Options for Changes in Federal Taxes to Encourage New Rental Construction

Prepared For:

Research Subcommittee
Housing Supply Working Group

Ontario Ministry of Municipal Affairs and Housing

By:

Greg Lampert
and
Steve Pomeroy

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Executive Summary

This report has been prepared on behalf of the Research Subcommittee of the Housing Supply Working Group (HSWG) – a joint government-industry advisory group established to identify rental housing supply problems and solutions. The HSWG is co-chaired by the Ontario Ministry of Municipal Affairs and Housing and industry representatives.

In May 2001, the HSWG released an interim report, *Affordable Rental Housing Supply: The Dynamics of the Market and Recommendations for Encouraging New Supply*, which called for action to encourage much-needed new rental investment. Among other things, the report recommended examination of several potential changes in the federal tax treatment of rental housing which could assist in stimulating new rental investment.

This report is one of three companion reports intended to address issues raised in the HSWG interim report and are background reports for the HSWG's second report: *Creating a Positive Climate fo. Rental Housing Development Through Tax and Mortgage Insurance Reforms.* The three reports include:

1. **Options for Changes in Federal Taxes to Encourage New Rental Construction** – development of a framework for the identification and analysis of potential changes to the federal tax system that would strategically improve the climate for new rental investment in Ontario – this report;
2. **The Context for Private Rental Housing Production in the US** – identification of the most significant tax and housing-related program levers impacting new market rental development in the US, how they work, how they generate capital for new market rental housing, and the potential for using such mechanisms in Canada; and
3. **Promoting a Positive Mortgage Insurance Environment for New Rental Construction** – examination of Canada Mortgage and Housing Corporation's underwriting practices and mortgage insurance fees for rental housing, and identification of options for the Province to promote improved access to mortgage insurance for new rental housing projects.

Facilitating an adequate supply of new rental housing is important to both a healthy housing system and a healthy economy. At present, there is clearly insufficient investment in new rental production in many centres in Ontario – a situation which must be remedied. Changes in the tax treatment of rental investment over the past three decades certainly bear at least part of the responsibility for the lack of new rental investment in Ontario today. Estimates presented in this report indicate that changes in the federal tax regime for rental housing since 1980 have substantially reduced the attractiveness of investing in new rental housing.

This report responds to the recommendation in the HSWG report regarding the federal tax treatment of rental housing by examining the following potential changes:

- Revising the rate and method used to calculate capital cost allowance (CCA) on rental housing

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- Allowing all investors in rental housing to utilize CCA losses in determining income for tax purposes – not just principal business corporations (PBCs)
- Allowing investors to deduct soft costs rather than capitalize them
- Allowing rental investors to defer capital gains tax and recaptured depreciation upon the sale of a rental project if the proceeds are reinvested in rental housing
- Allowing small landlords to qualify as small businesses for the purposes of obtaining the small business corporate tax rate
- Eliminating the capital tax on rental housing
- Full rebates of GST on new rental development, or zero-rating of rental housing.

For each potential tax change, the paper provides background and a description of the potential measure, an illustration of how the measure would impact on the economics of investment in new rental housing, and an assessment of the basis for introducing the change.

Any change in tax provisions will have a different impact depending on the characteristics of the investor. The report reviews the full range of potential rental investors and the extent to which each potential tax change would, or would not, affect a particular type of investor. For example, none of the potential income tax changes will have any direct impact on non-profit corporations, pension funds or Real Estate Investment Trusts (REITs); however, these potential investors would benefit from reductions in the GST on rental housing.

Principal business corporations (PBCs) are the types of investors most likely to consider developing new rental housing projects. Pension funds and REITs (the other major private investors in rental housing) generally prefer to acquire *existing* rental properties, which tend to be less risky since they have a stabilized income stream and known operating history. Individuals investing in rental housing are not considered to have the expertise necessary to plan and develop large rental projects – they typically purchase houses or condominiums or small existing apartment buildings.

While the analysis here, and in the companion report on the US, provides comparisons between Canada and the US tax treatment of rental housing, it should be noted that favourable tax treatment is an important factor stimulating rental investment in other countries, particularly Germany, New Zealand and Australia.

Assessment Framework

The report examines each of the potential tax changes in terms of:

- Effectiveness – would the measure improve the attractiveness of rental investment and result in increased new rental housing production?
- Fairness – is the measure justifiable in terms of equity with other similar types of investments?
- Practicality – would the measure be simple to implement, with the potential to target most of the benefits exclusively to investors in new rental housing projects?

Exhibit E-1 presents an overview of the assessment of each of the seven potential tax changes – based on the above three criteria. This exhibit also presents the potential tax changes in order of priority – based on an overall assessment of each according to the three criteria. It would be possible for the federal government to undertake each of the changes on a stand-alone basis and, for the purpose of assessment, is much simpler to present this way. However, this is not intended to imply that only one of the identified changes could, or should, be selected for implementation – clearly, a combination of tax changes would have a more significant impact on the economics of new rental development.

Exhibit E-1:

Assessment of Potential Tax Changes

	Effectiveness				Fairness	Practicality	
	Per Unit Change in After-Tax Cash Flow ($)*		Change in Per Unit Initial Equity ($)	Effect in Generating New Rental Investment		Simple to Implement	Easily Restrict to New Rental Housing
	Year 1	PV (25 yrs)					
Full rebate of GST on rental housing	182	2,597	2,553	Both lowers equity required and improves cash flow	Rental housing investors treated very differently from both other types of rental property, and other basic necessities (e.g. groceries)	Yes	Yes
Deferral of capital gains tax and recaptured CCA upon re-investment in rental housing	n/a	n/a	-	Difficult to quantify but provides important new source of investment capital	Rental property currently treated differently from other types of capital assets	Yes	Yes
Increase in CCA to 5%	213	2,079	-	Improves after-tax cash flow	Accelerated CCA allowed for some other types of investments	Yes	Yes
Restoration of soft cost deductibility ($5,000)	1,721	1,129	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Elimination of capital tax on rental housing	n/a	n/a	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Allowing small landlords to qualify as small businesses	n/a	n/a	-	Limited number involved in new development	Investors in rental housing appear to be treated differently from other types of small businesses requiring hands-on management	Yes	No
Extension of eligibility for CCA losses	n/a	n/a	-	Yes (for non-PBCs)	Life insurance companies are allowed to use CCA losses against other income	Yes	Yes

* The change in after-tax cash flow (compared to the current tax treatment) for a Toronto rental project with development costs of $141,400 (excluding GST).

In the assessment of the effectiveness of each potential change, where possible, the exhibit presents estimates of the effect of each change (with the specific parameters assumed in this analysis) on an investor's after-tax cash flow – for a typical new rental project in Toronto. Estimates are presented for both the initial year and over time (on a 25-year present value basis). The longer-term present value assessment is considered more meaningful than the initial year snapshot, especially in the case of the potential changes where tax liability is deferred.

These estimates reflect the difference between the after-tax cash flows under current tax rules and those that would be in effect if the proposed tax changes were implemented – thus the prioritization takes into account the degree to which the potential tax changes improve the attractiveness of investment. The exhibit also assesses the impact on the initial level of equity required – of the potential tax changes only the full rebate of GST affects required equity.

For many potential tax changes, it is neither feasible nor practical to develop a detailed cost impact, as there are too many unknown variables that influence the result.

Effectiveness

Almost all of the potential tax changes are considered likely to have some effect in generating new rental production, although some have a larger and broader impact than others.

Full rebate of the GST has an immediate impact in lowering the level of investor equity required and has a follow through favourable impact (not shown in this exhibit) on the investor's return on equity. Full rebate of GST would also benefit *all* types of rental investors – not just those which pay income taxes. Restoring immediate deductibility of all (or some) soft costs would have the largest quantifiable impact on after-tax cash flow in the critical first year following project completion. In terms of after-tax cash flow over time, the full rebate of GST and raising the CCA rate to 5% have the largest impact of the three potential changes where impact quantification is feasible.

Some of the potential changes defy quantification. For example, allowing owners of existing rental properties to defer capital gains tax and CCA recapture if the proceeds are reinvested in a rental property of equal or greater value would not directly affect cash flow, but could have a very significant impact in providing the new capital investment necessary to fund new development. For this reason, this potential change is ranked as the second highest priority.

Based on the analysis here, fully rebating the GST on rental housing, deferral of capital gains tax and recaptured depreciation (upon reinvestment in rental housing), increasing the CCA rate, and restoration of soft cost deductibility would be the most effective measures in stimulating new rental investment. The other measures would have a positive impact and could be effective complementary measures, but alone are not considered likely to have as significant an impact.

Fairness

Several of the potential tax changes would rectify some degree of inequity in the current tax environment, compared with the tax treatment of other types of investments:

- **Deferral of capital gains tax and recaptured depreciation upon re-investment in rental housing** – such deferral is allowed for other types of capital investments if the investor purchases another similar investment. In this regard, rental real estate is treated differently from other types of capital investments.

- **Fully rebating rental projects for the GST** – an investment in new rental housing attracts 4.5% GST, unlike commercial rental properties which effectively do not bear the GST. In this regard, rental housing is treated differently from other types of real estate investments. An equity argument in favour of full rebates can also be made in comparison with the GST treatment of groceries – another basic necessity. Groceries are zero-rated – i.e. GST is neither collected on the sale of groceries (like the case with rental housing, where GST is not collected on rent) nor payable on the inputs required to produce groceries (unlike the case with rental housing). While a fairness argument can equally be made to zero-rate rental housing, such a change would have a very broad impact – across the total stock of rental housing, where GST is payable on operating costs. Accordingly, this analysis deals with a full rebate of GST on rental development costs – this would both limit the federal revenue losses and more effectively target the benefits towards improving the attractiveness of investment in new rental housing.

- **Allowing small landlords to qualify as small businesses** – businesses which invest in and manage real estate are effectively barred from qualifying for the small business deduction. In this regard, they are treated differently from other types of businesses which require hands-on management. Instead of recognizing that they must actively manage their rental properties, small real estate businesses are treated the same as businesses which invest in stocks, bonds and other types of passive investments.

- **Increasing the CCA rate and extension of eligibility for CCA losses** – on the basis of existing inequities in the tax system, a case can also be made for increases in the CCA rate and extension of eligibility for CCA losses to other types of investors. Some investments (e.g. aircraft) are allowed much greater accelerated depreciation. Similarly, life insurance companies are allowed to claim CCA losses on rental investments against other income but this is not allowed for other non-PBC types of investors.

Practicality

In the case of the CCA revisions, the report examines a number of broader options, in addition to increasing the rate to 5%. These other options include relaxing the half-year rule, and changing the method from a declining balance to straight-line depreciation (as used in the US). Since these represent fundamental change across the entire Canadian income tax system, they are not considered practical – only the increase in the CCA, which could be implemented without fundamental change to the tax system, is included in this assessment.

Similarly, zero-rating rental housing might be justified on the basis of fairness; however, this may not be practical due to the broad scale impact of such a change on federal revenues. Therefore, full rebate of the GST on the development cost of new rental housing is the potential measure considered here. It would provide most of the benefits of zero-rating (in terms of enhancing the attractiveness of investment in new rental housing), without the significant cost implications (or administrative changes) associated with zero-rating.

Other than these issues, none of the potential tax changes would appear particularly difficult to implement. They would require modest changes in tax policy and procedures, but such measures are routinely undertaken by the federal government.

Also, most of the measures could relatively easily be restricted to new rental housing so, if desired, the measures could be targeted exclusively to benefit new rental production. This would help to ensure that the impacts are well targeted and would limit the associated impact on federal tax revenues.

Current Rental Production

The primary objective of the potential tax changes would be to restore the attractiveness of rental investment and to stimulate new rental development. However, the changes cannot be exclusively focused on the resulting new increment of rental production – each measure, if implemented, would apply also to any other new rental development. Therefore, in assessing the impact of the potential tax measures on federal revenues (below), it is necessary to determine the total volume of new rental development likely to be built without these tax revisions, as well as the possible volume of incremental new rental units that might be stimulated by the potential tax changes.

CMHC is forecasting new purpose-built rental starts totalling roughly 13,500 in 2002. This includes projects developed by private for-profit (primarily PBCs, 10,000 units) and by not-for-profit corporations (3,500 units) which are subject to different tax treatment. In addition, a number of rental units are created within the condominium sector but purchased by individual investors seeking to rent them out. These individual investors may qualify for some of the tax changes discussed above. It is estimated that 25% of condominium units across Canada could be built in response to demand by these small investors, producing an estimated 8,000 additional new rental units in 2002 – so total new rental production in 2002 is forecast at 21,500 units.

Since the magnitude of the stimulative impact which would result from adoption of the potential tax changes is unknown, three illustrative potential levels of additional incremental rental starts are identified – increases of 5,000 and 10,000 units, over and above the base forecast production of 21,500 units.

Cost-Benefit of Potential Tax Measures on Federal Tax Revenues

The report identifies five main sources of federal revenues that are impacted directly by new rental construction: personal and corporate income taxes, GST, Canada Pension Plan (CPP) contributions and Employment Insurance (EI) contributions. Although CPP contributions flow into a separate account (the CPP reserve fund), all five sources are included here. It is estimated that the construction of 21,500 new rental units generates roughly $510-$656 million in revenues to the federal government from these sources.

In addition, rental production would have a beneficial impact on other parts of the federal treasury (e.g. profits generated from CMHC insurance, duties on imported construction materials, reduced EI claim payments from construction workers, etc.), but these are not quantified in this analysis.

Exhibit E-2 presents an overview of the estimated revenues from currently forecast rental construction, as well as the net impact on federal revenues from incremental rental production which might result from adoption of the three potential tax changes with federal revenue impacts that can be readily quantified – CCA increase to 5%, immediate deductibility of soft costs, and fully rebating the GST. In the exhibit, each measure is presented on a stand-alone basis and a low-high range estimate of federal revenue impacts is presented.

Exhibit E-2:
Net Impact of Potential Tax Changes on Federal Revenues
($Millions)

	5% CCA		$5,000 Soft Cost		Full Rebate GST	
	Low	High	Low	High	Low	High
Base Benefits from Current Forecast Production						
Total Current Revenue	510	656	510	656	510	656
Total Foregone with Tax Change	18	24	7	7	87	116
Net Revenue with Tax Change	492	632	503	649	423	540
Additional Revenue from Incremental Units Only						
5,000 Additional Units	114	146	116	150	99	126
10,000 Additional Units	227	292	230	298	197	251
Total Revenues from Rental Production (with Tax Changes)						
Current Production	492	632	503	649	423	540
- Plus 5,000 Incremental Units	606	779	619	799	522	666
- Plus 10,000 Incremental Units	719	924	733	947	619	791

Highlights of Exhibit E-2 include:

- With the anticipated annual starts of 21,500 units (including private rental, investor-owned but rented individual condominium units, and non-profit units), total federal revenues from new rental construction are estimated to range from $510-$656 million.

- The effect of implementing the three potential tax changes which have been quantified, applied against this base forecast, results in a reduction in federal revenues of:

  - $7 million for allowing immediate deductibility of $5,000 in soft costs;
  - $18-$24 million for raising CCA to 5%; and
  - $87-$116 million for a full rebate of GST on rental development costs.

- Depending on the number of incremental rental units stimulated by adoption of the potential tax changes, the revenue benefits to the federal government could be substantial.

For each of the potential tax changes, the exhibit presents estimates of the incremental federal revenues which would flow from incremental rental production of 5,000 and 10,000 units.

- An increment of 5,000 rental starts would generate additional net federal revenues of $114-$150 million for the CCA or the soft cost changes – well above the modest revenue losses from current forecast production from either of these changes. The revenue gain is lower for the GST change ($99-$126 million).

- Additional incremental starts (spurred by the tax changes) of 10,000 units would double this additional federal revenue.

- Assuming that adoption of any of the potential tax changes results in additional rental starts of 5,000 units or more, the net impact on federal revenues is positive – i.e. the additional revenue from the higher level of production more than offsets the revenue foregone from the 21,500 base level of rental production as a result of the tax changes. The additional federal revenues from 5,000 incremental units would total $99-$150 million (depending on the tax change involved) – the additional federal revenues are greater than foregone revenues in all of the scenarios (assuming at least 5,000 incremental rental units).

- The total federal revenues from rental production would grow significantly if the tax changes stimulate additional rental production. From a base level of $510-$656 million from currently forecast rental production, even the (relatively expensive) GST change would result in increased federal revenues: $522-$666 million (5,000 incremental units); $619-$791 million (10,000 incremental units).

Although not shown on the exhibit, production of roughly 6,000 incremental units fully covers the revenue losses incurred by extending *all three* of these changes across the base forecast of 21,500 units. Any new development beyond this level would generate a net revenue gain for the federal treasury.

In sum, the potential tax changes examined here would result in higher rental production, while the foregone federal revenues would be at least partially offset by additional revenues from the increased volume of rental construction. At the same time, as a direct consequence, the higher volume of rental production would lead to healthier housing markets. The new rental supply would help to relieve current very tight rental markets which, in turn, would reduce upward pressure on rents and effectively moderate the degree to which rising rents (caused in part by lack of supply coupled with new demand from population and household growth) exacerbate affordability problems.

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1. Introduction

This report has been prepared on behalf of the Research Subcommittee of the Housing Supply Working Group (HSWG) – a joint government-industry advisory group established to identify rental housing supply problems and solutions. The HSWG is co-chaired by the Ontario Ministry of Municipal Affairs and Housing and industry representatives.

In May 2001, the HSWG released a report, *Affordable Rental Housing Supply: The Dynamics of the Market and Recommendations for Encouraging New Supply*, which identified various actions which could assist in stimulating new rental investment. The report concluded that key changes in the tax climate for rental housing should be considered to encourage new rental supply. Recommendation 1 (of 12 recommendations contained in the report) states:

> It is recommended that the Province and industry work with the federal government to identify key changes to the tax system which would stimulate rental supply. This should include consideration of rollover provisions, passive vs active designation, GST and capital tax. In particular, given the conclusions of a background study undertaken by Ernst and Young comparing rental economics in the US with those in Ontario, it is recommended that particular attention be paid to the ability to rollover capital gains tax and the amount of allowable annual CCA deduction.

This report responds to this recommendation by examining the arguments in favour of such tax changes and assessing their effectiveness in encouraging new rental development. The potential tax changes examined here include:

- Revising the rate and method used to calculate capital cost allowance (CCA) on rental housing
- Allowing all investors in rental housing to utilize CCA losses in determining income for tax purposes – not just principal business corporations (PBCs)
- Allowing investors to deduct soft costs rather than capitalize them
- Allowing rental investors to defer capital gains tax and recaptured depreciation upon the sale of a rental project if the proceeds are reinvested in rental housing
- Allowing small landlords to qualify as small businesses for the purposes of obtaining the small business corporate tax rate
- Eliminating the capital tax on rental housing
- Full rebates of GST on new rental development, or zero-rating of rental housing.

In addition to this introduction, the paper includes the following sections:

2. **The Illustrative Rental Project** – the financial characteristics of a typical new rental housing project. This project is used (in Section 4) to demonstrate the financial impacts of the potential tax changes.
3. **Types of Rental Investors** – a description of how different types of potential rental investors would (or would not) be affected by each of the potential tax changes, and identification of those types of investors which are most likely to invest in new rental housing.

4. **Analysis of Potential Federal Tax Changes** – an examination of each of the potential tax changes, and an assessment of each potential change in terms of effectiveness, fairness and practicality.
5. **Fiscal Impact of Potential Tax Changes** – an assessment of the effect of potential tax changes on federal government revenues.
6. **Overall Assessment of the Potential Tax Changes** – a comparative review of the effectiveness, fairness and practicality of each of the potential tax measures.

The purpose of this report is to expand understanding of the potential tax changes to assist the HSWG in identifying those which have the most promise.

2. The Illustrative Rental Project

Exhibit 2-1 presents a simplified version of a pro forma of the costs and revenues associated with developing a new rental project in Toronto.

Exhibit 2-1:

Pro Forma
Illustrative New Rental Project, Toronto
($ per Unit)

PROJECT DEVELOPMENT COSTS		**PROJECT FINANCING**	
Land (+ Development Charges)	24,400	Equity	23,763
Construction Costs	117,000	Financing	124,000
	141,400	**Total Costs**	147,763
GST	6,363	Mtg Ins Fee	5,580
Total Costs	147,763	**Total Financing**	129,580

ANNUAL REVENUES, COSTS AND CASH FLOW

		Year 1	*Year 5*
Revenues:		16,300	17,644
Operating Costs:	Maintenance and Operations	2,000	2,165
	Property Taxes	1,900	2,057
	Total Operating Costs	3,900	4,221
	Net Operating Income	12,400	13,422
Mortgage Payments:	Principal	2,168	2,800
	Interest	8,248	7,616
	Total	10,415	10,415
Cash Flow:		1,985	3,007
Cash-on-Cash Return		8.4%	12.7%
Cap Rate (NOI/Total Cost):		8.4%	9.1%

Note: Totals may not add due to rounding

The pro forma presented in Exhibit 2-1 was formulated by Greg Lampert recently for an assignment for the City of Toronto. It is considered to be generally representative of the current economics for a new medium-quality high-rise rental development in Toronto[1] – pro formas developed for previous reports are considered to have been rendered obsolete by escalating land and construction costs, higher achievable market rents, and a reduction in municipal property taxes, among other things.

The project described here is used in Section 4 to assess the effects of various potential changes in federal taxes on the attractiveness of investment in new rental housing.

Overview of Illustrative Project

Key elements of the pro forma presented in Exhibit 2-1 include:

- **Project Costs** – land costs of $24,400, including City and education development charges and a City parkland fee; total construction costs are assumed to be $117,000. So the total costs of development are $141,400, not including GST. With 4.5% GST, the total costs are $147,763 per unit.

- **Revenues** – initial year market rents (not including utilities):

1-bed	$1.85/ft	650 sq.ft.	$1,200/mo	$14,400/yr
2-bed	$1.70/ft	850 sq.ft.	$1,445/mo	$17,340/yr

  Based on the above, average rent revenue would be $15,870 per unit, less vacancies (2%) – i.e. $15,550 per unit. Sundry revenues (parking and laundry) are assumed at $750/unit annually. So, total revenues are $16,300. For simplicity, it is assumed that the project is fully occupied at the beginning of Year 1 so the first year revenues (and operating costs, below) are for a full year. In reality, of course, it takes some time for the project to 'rent-up' – a period when losses are typically generated (this is discussed further, below).

- **Operating costs** – these are assumed to total $2,000 per unit in the first year. This excludes in-suite utilities, which are paid by the tenant.

- **Property taxes** are assumed to be $1,900. This is well below the taxes which would have applied under the multi-residential tax rate for existing rental projects.[2]

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[1] This building quality and rent level is illustrative of a new project at the low margin of viable unsubsidized rental development – most new rental development is at higher rent levels. While lower rent, more affordable, stock is desirable to meet the needs of lower income renters, the economics for more modest construction are much less tenable, and hence do not provide a realistic assessment of the types of projects that developers might be prepared to build (unless the government offers direct subsidies or incentives).

[2] There is a significant difference in the property taxes payable on dwellings in the residential/farm class (i.e. detached homes as well as condominium-registered apartments) versus the multi-residential (rental) class. Recently, the Province has enacted legislation enabling municipalities to create a new tax class (with lower taxes) specifically for new rental development.

- **Net operating income (NOI)** – the difference between revenues and operating costs (including property taxes).

- **Mortgage financing** – a mortgage equivalent to 85% of the lending value financed at 6.5% over 25 years.[3] At an 85% loan to value ratio, the new CMHC mortgage insurance premium is 4.5%. The total mortgage (including the CMHC fee) is $129,580.

The simplified pro forma presented in Exhibit 2-1 is similar in structure to those used in previous work by the consultants. Since most readers will be familiar with pro formas, a detailed analysis of the various components is deemed unnecessary for this report – readers who would like to obtain more background about how the various components of the pro forma fit together can consult the report *Responding to the Challenge: The Economics of Investment in new Rental Housing in 1999*, prepared by Greg Lampert for MMAH in February 1999 (pages 13-28).

Financial Performance of the Illustrative Project

Exhibit 2-1 presents a simplified view of the financial performance of the illustrative project. Key financial variables include net operating income (NOI) from the project (the funds generated by revenues less the costs of operating the project), and cash flow (NOI less the mortgage payments). The exhibit also presents two financial ratios:

- **Cash-on-cash return** – cash flow expressed as a percentage of the equity. This is the raw return on equity, not considering other potential benefits (e.g. capital appreciation, mortgage repayment, and taxation considerations). The higher the cash-on-cash return, the more attractive the investment.

- **Cap (capitalization) rate** – NOI as a percentage of the total cost of developing the project. Cap rates for good quality existing rental buildings in the Toronto area are roughly 8%, so a higher cap rate for a new project would be required to attract investors, given the significant risks involved in developing a new rental project.

The pro forma in Exhibit 2-1 does not attempt to illustrate the after-tax situation for investors. This is provided in Exhibit 2-2 which presents estimates of the taxable income (and deductions) for investors in the new rental housing project for the first six years.[4] For the purposes of this illustrative example, it is assumed that the investor is a 'principal business corporation' (PBC) – i.e. a company which is principally in the business of real estate (see Section 3).

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[3] CMHC insures mortgages for rental projects based on the lesser of 85% of cost or estimated lending value. CMHC has announced changes to the underwriting criteria and premiums effective March 2002 (see separate report – *Promoting a Positive Mortgage Insurance Environment for New Rental Construction*). For the analysis here, it is assumed that CMHC applies an 8.5% cap rate – the lending value is therefore $145,882 (NOI/ cap rate; $12,400/0.085); a mortgage for 85% of lending value would be $124,000.

[4] The purpose here is to explain the implications of taxes on new rental investment in as straightforward and simple a manner as possible. It is considered that excessive precision and detail would unnecessarily confuse the analysis; so the estimates presented in Exhibits 2-1 and 2-2 involve many assumptions (and, sometimes, oversimplifications) about the costs and revenues associated with a new rental project.

Exhibit 2-2:

Income for Tax Purposes
Illustrative New Rental Project, Toronto

($ per unit)

	'Rent-Up' Year	Year 2	Year 3	Year 4	Year 5	Year 6
Income and Operating Expenses:						
Revenues	10,867	16,626	16,959	17,298	17,644	17,997
Operating Costs	3,900	3,978	4,058	4,139	4,221	4,306
NOI	6,967	12,648	12,901	13,159	13,422	13,691
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	2,431	4,765	4,575	4,392	4,216	4,047
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	12,495	13,986	13,643	13,297	12,948	11,478
Taxable Income	(5,529)	(1,338)	(742)	(138)	474	2,212
Depreciable Balance:						
Start of Year	121,565*	119,134	114,368	109,794	105,402	101,186
CCA	2,431	4,765	4,575	4,392	4,216	4,047
End of Year	119,134	114,368	109,794	105,402	101,186	97,138

* Construction Cost ($117,000) + GST on construction ($5,265) - deductible costs (landscaping $700)

Key elements of Exhibit 2-2 include:

- **The 'rent-up' period** is included in this analysis – unlike the pro forma presented in Exhibit 2-1 which was based on the simplifying assumption that the project is fully occupied at the beginning of Year 1. The analysis here recognizes the reality that rental projects are not fully occupied immediately upon completion. This is important in the analysis of taxes payable by the investor since the tax treatment of income for the first year is different from subsequent years.

  For the analysis here, it is assumed that the project rent-up is complete after the rent-up year, and that revenues during this year are two-thirds of the Year 1 level shown in Exhibit 2-1. The operating costs, property taxes and mortgage payments for Year 1 (from Exhibit 2-1) are assumed to apply for the rent-up year.

- **Years 2-6** – the revenues and costs are assumed to rise by 2% annually. For revenues, the 2% increase is based on the full year revenues presented in Exhibit 2-1 rather than the revenues accruing in the rent-up period when there would be substantial vacancies.

- **NOI** represents the income from the project after payment of the costs of maintenance and operations, plus property taxes. The NOI for the rent-up period has been estimated from the above and is, therefore (as a result of the lower revenues due to vacancies), less than that shown in Exhibit 2-1.

- **Deductions** – several items are deductible from NOI in determining income for tax purposes:

  - **Interest costs** – these are from Exhibit 2-1, where interest payments are shown separately from principal repayments.
  - **CCA** – as discussed in Section 4.1, the 'half-year rule' restricts CCA in the first year to 2% (i.e. half of the normal rate of CCA); in subsequent years, the CCA is 4% of the declining depreciable balance. CCA applies only to the construction costs, plus GST on these costs; it does not apply to land.
  - **Other deductions** – these include special items such as the mortgage insurance fee (which is assumed to be deducted in equal installments over five years) and landscaping costs (which are deductible in the first year). Landscaping costs are assumed to total $700 per unit. As discussed in Section 4.3, 'soft costs' (which formerly could be deducted in the early years of a rental project) must be capitalized into the depreciable value of the project.
  - **Total deductions** are somewhat smaller in the first year compared to subsequent years – due to the lower CCA resulting from the 'half-year rule'. After Year 2, CCA gradually declines since each year's CCA reduces the depreciable balance.

- **Taxable income** is NOI less total deductions. In the first year, the project generates substantial negative income for tax purposes ($5,529) – as a result of a combination of the low income due to vacancies during rent-up, plus the deductions. In subsequent years, the project generates progressively smaller losses for tax purposes. There is a modest positive taxable income in Year 5. In the sixth year, the deduction for the mortgage insurance fee (which was assumed to be spread over 5 years) expires, and the project generates more positive taxable income.

  While the project generates negative income for tax purposes in Years 2-4, in fact, on a cash basis, the project is generating positive cash flow from Year 2 on – i.e. except for the interest costs (and principal repayments), the other (tax-related) deductions from NOI do not actually lead to a cash outlay for the investor.

  When calculating the income taxes payable by the investor, the negative taxable income shown in Exhibit 2-2 can be fully utilized by PBCs as a deduction against income from other sources. Other types of investors are not allowed to utilize CCA to create losses deductible from income from other sources[5] – so, for example, in the first year, such investors would have a much smaller loss of $3,097 [$6,967 - ($8,248 + $700 + $1,116)] to apply as a deduction from income from other sources. In subsequent years, non-PBC investors could utilize CCA only insofar as it reduced income to zero for tax purposes – this is discussed further in Section 4.2.

Exhibits 2-1 and 2-2 present a (very simplified) summary of the financial performance of the illustrative rental project under today's tax regime. These form the 'base case' against which the effects of the potential measures to encourage new rental investment are assessed in Section 4.

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[5] If, however, the investor owns other rental properties, the CCA can be used as a deduction against income from these properties.

3. Types of Rental Investors

Changes in the tax treatment of rental housing will not affect all types of potential rental investors in the same way. For example, many of the potential changes involve the income tax treatment of rental housing; however, some investors, such as pension funds and non-profit corporations, would be indifferent to such changes because they do not pay income taxes. Principal business corporations are considered to be the most likely candidates to undertake new rental development and are, therefore, the primary target of the potential tax changes discussed in this report. Institutional investors (the other major investor in rental housing) generally prefer to acquire *existing* rental properties, which tend to be less risky since they have a stabilized income stream and known operating history.

Exhibit 3-1:

Effect of Potential Tax Changes on Propensity to Invest in NEW Rental Housing Developments

	Principal Business Corps	Pension Funds	REITs	Non-Profit Corps	Other Corps	Individuals
Increasing the CCA Rate	Positive	No effect	Positive	No effect	Positive	Positive
Allowing all rental investors to utilize CCA	No effect	No effect	No practical effect	No effect	Positive	Positive
Restoration of soft cost deductibility	Positive	No effect	Positive	No effect	Positive	Positive
Tax-deferred rollover	Very Positive	No effect	Positive	No effect	Positive if own rental properties	Positive if own rental properties
Small business designation	Positive for small companies	No effect	No effect	No effect	Positive for small companies	Positive - if they incorporate
Elimination of capital tax	Positive	No effect	No effect	No effect	Positive	No effect
Zero-rating of rental housing	Positive	Positive	Positive	Positive	Positive	Positive

Exhibit 3-1 reviews the main types of rental investors – and how the potential changes in the taxation of rental housing might affect their willingness to invest in new rental housing projects. The main types of rental investors include:

- **Principal business corporations** (PBCs) – corporations whose principal business is the leasing, rental, development, or sale of real property. PBCs receive more favourable income tax treatment than other types of investors in rental properties – see Section 4.2. Most of the potential federal tax measures would be positive for PBCs investing in new rental projects; however, the measure to extend CCA deductions (to reduce non-real estate income) to all rental investors would not affect PBCs since they already enjoy the beneficial treatment which this measure proposes to extend to others.

- **Pension funds** – changes in the income tax treatment of rental housing would not generally affect the attractiveness of rental investment for pension funds, since they are not subject to income tax. Of the potential changes, only changes to the GST would affect the returns to pension funds from rental investment.

- **Real Estate Investment Trusts** – REITs invest in real estate and provide distributions to unitholders based on the resulting income. REITs do not pay tax on their income; instead income flows through to unitholders and is taxed in their hands as a combination of tax-free 'return of capital' (i.e. CCA deductions) which are not subject to income tax (but reduce the cost base for determining capital gains tax when the investor sells the units) and other income, which is taxable. Unlike the case with PBCs, many of the potential federal tax changes would not affect REITs investing in new rental projects: allowing all investors to utilize CCA, allowing small business designation, and elimination of capital tax would not affect REITs.

- **Non-profit corporations** – non-profits do not typically pay any income taxes on their investments, so they would not benefit directly from any of the potential measures with respect to the income tax treatment of rental housing.[6] Zero-rating of rental housing for the GST would be the only potential measure examined here which would be positive for non-profits planning to invest in new rental projects.

- **Other corporations** – companies which own (or seek to own) real estate, but are not classed as PBCs, would benefit from all of the potential federal tax measures.

- **Individuals** – most of the potential measures would be positive for individuals investing in rental housing.

From the above, it is clear that not all types of investors in new rental housing would be affected by the various potential tax measures discussed in this report. These differences among the various types of investors need to be borne in mind in the assessment of each of the measures (in Section 4).

The Most Likely Investors in New Rental Housing

A key purpose of this report is to assess how effective each of the potential tax changes would be in stimulating new rental housing development. Therefore, since the changes would not affect all types of potential investors in the same way, it is important to recognize which types of investors might be most likely to undertake the development of new rental housing.

Real estate development requires a combination of a high level of expertise, access to capital and a capacity and willingness to take significant risks. In this context, PBCs appear to be the most likely developer on new private rental housing projects and, therefore, are a promising target for

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[6] Non-profits could benefit indirectly from the deferral of recaptured depreciation and capital gains taxes to the extent that the measure might create an additional 'supply' of existing rental projects which might be suitable for purchase by non-profit organizations.

measures that seek to promote new rental development. The other types of investors are considered less likely candidates for developing new rental projects:

- REITs and institutional investors typically prefer to acquire *existing* properties with a proven track record and stable income.[7] They could therefore be an important source of investment if deferral of CCA and capital gains were adopted – they would be potential purchasers of existing properties sold by PBCs seeking to reinvest.

- Individual investors or partnerships have traditionally played a very important role in the rental market – a large proportion of existing rental properties are owned and operated by these 'mom and pop landlords'. However, on their own, they typically lack the expertise to undertake new development, even for small properties – more often they acquire existing buildings.

- Non-profit corporations are not impacted by tax considerations, other than the GST.

Nonetheless, these non-PBC investors can play an important role in encouraging investment in new rental developments by purchasing existing properties owned by PBCs (including those built and operating for a significant period) and creating the liquidity necessary to provide PBCs with the capital necessary for new development.

Facilitating syndicated limited partnerships in rental housing is another possible means of promoting new rental development. These are a hybrid investment vehicle whereby expertise in rental development is provided by a general partner, and shares in a limited partnership are sold to individual (typically higher income) individual investors seeking a passive investment – e.g. the MURB (Multiple Unit Residential Building) syndications in the late 1970s and early 1980s).

As discussed in Section 4.2, MURBs were tax shelters which typically generated 'paper losses' for investors to use to shelter income from other sources. While they were extremely successful in stimulating investor interest in new rental construction, MURBs were terminated by the federal government in the early 1980s – and replaced with temporary grant and interest-free loan programs. Compared to the benefits which they generated (i.e. new rental construction), MURBs were considered to convey a disproportionately favourable level of tax savings to high-income investors, and especially to the companies which packaged the investments to attract the investors. Termination of MURBs was part of a federal government effort to curb revenue losses by limiting the ability of high-income investors to avoid taxes through the use of aggressive tax shelters.[8] Nonetheless, tax shelters have not entirely been eliminated – e.g. film tax shelters (another vehicle which has been criticized on efficiency grounds).

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[7] Institutional investors (including pension funds and life insurance companies) are often active in new rental development in an indirect way – as the source of mortgage funds.

[8] Although MURBs were considered to be relatively inefficient, this was at least partly a function of program design, and not necessarily an inherent feature of the tax expenditure approach. As discussed in the companion paper, *The Context for Private Rental Housing Production in the US* by the same authors, the US Low Income Housing Tax Credit has also been criticized as being inefficient; however, refinements to the design of the program in recent years have addressed many of these concerns and achieved a better targeting of tax expenditures towards achieving public policy objectives.

From the above, it would appear that PBCs are the potential investors most likely to have the combination of talents and resources required to undertake the development of new rental housing projects. However, from past experience, it would appear that individual investors (particularly those with high incomes) could also be attracted to syndicated investments in rental housing – provided there were sufficient tax shelter benefits. PBCs and (to a lesser extent) individuals are the primary focus of the analysis of potential federal tax changes in Section 4.

4. Analysis of Potential Federal Tax Changes

This section presents an assessment of several potential changes in taxes relating to investment in new rental housing. As noted in the introduction, the potential changes examined here include:

1. Revising the rate and method used to calculate capital cost allowance (CCA) on rental housing
2. Allowing all investors in rental housing to utilize CCA losses in determining income for tax purposes – not just principal business corporations (PBCs)
3. Allowing investors to deduct soft costs rather than capitalize them
4. Allowing rental investors to defer capital gains tax and recaptured depreciation upon the sale of a rental project if the proceeds are reinvested in rental housing
5. Allowing small landlords to qualify as small businesses for the purposes of obtaining the small business corporate tax rate
6. Eliminating the capital tax on rental housing
7. Full rebates of GST on new rental development, or zero-rating of rental housing.

In each case, a brief background and description of the potential measure is provided, followed by an illustration of how the measure would impact on the economics of investment in new rental housing, and, finally, an assessment of the basis for introducing the measure. The assessment examines each of the measures in terms of:

- Effectiveness – would the measure improve the attractiveness of rental investment and result in increased new rental housing production?
- Fairness – is the measure justifiable in terms of equity with other similar types of investments?
- Practicality – would the measure be simple to implement, with the potential to target most of the benefits exclusively to investors in new rental housing projects?

In this section, the seven potential changes are not examined in order of priority. The order was adopted simply to facilitate the presentation and understanding of the measures. In Section 6, the options are collectively assessed and prioritized, based on the above assessment criteria. Also, it needs to be borne in mind that, while each potential change is examined on a stand-alone basis, there would be benefits from combining two or more of the measures. However, none of the potential changes examined here is dependent on the implementation of any other.

Tax Changes or Grants?

Rental housing is part of a larger housing system, but tends to be the sector that accommodates most lower income households. These households have little option but to rent, and are vulnerable when tight rental markets lead to rising rents. While most rental housing is privately developed and operated, it is a public or merit good in the sense that it a necessary part of a healthy housing system. Since there has been little new private rental development for many years, this is a cause for concern – and questions about why.

Clearly, the potential returns from development of new rental housing are not sufficiently attractive, given the returns available from alternative investments. New rental development is a risky investment, so investors need a return sufficient to compensate for the risks involved. The federal tax regime for rental housing is an obvious candidate for examination since, as is discussed below, there have been so many changes in the tax treatment of rental investment over the period since the early 1970s – the last period when there was substantial unsubsidized rental production in Canada.

However, changes in the tax regime for rental investors are only one option to improve the attractiveness of rental investment. In assessing the benefits of more favourable tax treatment for rental housing, readers need to bear in mind the alternative of a direct expenditure, such as a grant or interest-free loan. In general, direct program spending tends to be viewed by government officials as more transparent and efficient than an equivalent benefit provided through tax expenditures.

Nonetheless, in assessing the best means of addressing the underproduction of rental housing, it is sensible to examine whether the tax regime for rental investment is fair – or whether it is responsible for the underproduction. Also, an argument can be made that tax changes may be more effective in influencing investment decisions than direct program expenditures, particularly in cases of high risk – such as rental investment. There are many precedents for using the tax system to promote particular types of investments, or to influence investors' decision-making – Labour Sponsored Venture Capital Funds, flow-through shares for resource exploration, and RRSP deductibility are only a few of the many examples of tax expenditure programs which seek to influence investor behaviour. Finally, given the experience of the rental housing industry with on-off short-term government programs, changes in the tax treatment of rental housing appear likely to be a more effective way of restoring a positive investment environment than temporary direct spending programs.

Facilitating an adequate supply of new rental housing is important to both a healthy housing system and a healthy economy. At present, there is clearly insufficient investment in new rental production – a situation which must be remedied. Changes in the tax treatment of rental investment over the past three decades certainly bear at least part of the responsibility for the fact that new rental housing is not an attractive investment. PBCs, the main likely candidates for investment in new rental development, have instead concentrated on other investments (e.g. commercial developments) or have become developers/builders of detached home sub-divisions or condominiums – which generate more favourable returns. Tax changes appear likely to be an effective way of encouraging PBCs back to new rental housing development.

4.1. Revising the CCA Treatment of Rental Housing

Background

As noted in Section 2, at present, the rate of depreciation (capital cost allowance – or CCA) allowed for rental projects is 4% of the declining depreciable balance annually – this applies to both residential rental projects and non-residential rental projects. For new rental projects, the 'half-year rule' specifies a rate of 2% for the initial year.

This contrasts with the more favourable CCA available to rental investors prior to the significant changes introduced by the federal government during the 1970s and 1980s:

- For wood-frame buildings, the CCA rate was 10% annually for most of the 1970s (compared to 5% for other types of rental buildings). This differential was terminated in 1978 and the CCA allowed on buildings acquired after that date was fixed at 5%.
- The half-year rule was introduced in 1981. This restricted the CCA deductions for the year a depreciable asset is acquired to one-half the normal CCA rate. The half-year rule applies to most depreciable assets, not just buildings.
- In 1988, the CCA rate for rental buildings was reduced from 5% to 4% for buildings acquired after that date.

These changes in the CCA treatment of rental investment (and others, such as changes in the soft cost provisions – see Section 4.3) were part of a series of changes introduced by the federal government during the 1970s and 1980s, in part, to curb the use of aggressive tax shelter syndications.

In the US, the depreciation on rental properties is 3.64% on a 'straight-line' basis over a 27.5 year period – i.e. a fixed annual amount. In contrast, the allowable CCA in Canada is a slightly larger proportionate share of a declining balance – the result is that CCA deductions tend to be slightly larger in Canada in the first few years of a rental investment and then progressively less over time, compared to the US. Also, in the US, the depreciation allowed in the first year depends on when in the year the property is acquired – for property acquired early in the year, a proportionately larger share of the annual depreciation can be used as a deduction than for properties acquired later in the year. In contrast, in Canada, one-half of normal CCA may be deducted no matter when during the year the property is acquired.[9]

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[9] While the analysis here and in the earlier Ernst and Young study (*Comparative Real Estate Finance Analysis*, 2001) provides comparisons between Canada and the US tax treatment of rental housing, it should be noted that favourable tax treatment is an important factor in rental investment in other countries, particularly Germany, New Zealand and Australia. For example in order to stimulate rental development, in 1989, Germany increased the depreciation rate to 7.0% for the first 4 years, 5% for years 5-10 and then 1.25 in each of the next 24 years. This was designed to provide greater relief in the early years and to enhance after tax rates of return. See *Private Rental Policies and Programs: Review of the International Experience*, prepared by Steve Pomeroy, Greg Lampert and Kathleen Mancer for CMHC, 1998.

Effect of an Increase in CCA Rate

Exhibit 4-1 presents estimates of the taxable income of an investor in the illustrative rental project under three different scenarios:

- Current tax treatment.
- A 5% CCA rate applicable from the first year (i.e. an increase in CCA from 4% to 5% retaining the half-year rule).
- A 5% CCA rate applicable from the first year (i.e. an increase in CCA from 4% to 5% and abolition of the half-year rule). This would return the CCA rules to those which applied (to non-wood-frame buildings) prior to 1981.

As illustrated in the exhibit, raising the CCA to 5% increases the amount of the loss (which PBCs can deduct against income from other sources) and extends the period during which taxable income is negative. Abolishing the half-year rule (in addition to raising the CCA rate to 5%) would also be beneficial as it increases the extent of negative income in the first year. This is highly favourable to potential investors since the deductions available to apply to income from other sources increase significantly – especially in the critical early years of the project.

In assessing the effects of these changes, the key lines in the exhibit are *CCA* and *taxable income*. Taxable income is determined by subtracting total deductions (including CCA) from the NOI – which, as discussed in Section 2, is not affected by changes in CCA or other deductions. A higher negative taxable income from the project is beneficial to an investor (from an income tax perspective) since this negative taxable income can be used as a deduction against the investor's income from other sources.[10] Key elements in the exhibit include:

- In the first year, due to the half-year rule, the current allowable CCA is much reduced from what would apply if full CCA deductions were allowed. Allowing full deductibility alone would increase the 'loss' for tax purposes (i.e. negative taxable income) to over $7,960 (not shown in the Exhibit) from the $5,529 which applies under current tax rules. Raising the CCA rate to 5% would increase the losses for tax purposes to almost $9,175.

- In later years, the losses available to deduct from other income diminish; however, in comparison with the current tax treatment, they are much more favourable to the investor.

- The increase in the rate of CCA to 5% results in an acceleration of the reduction in the depreciable balance for the project so, later in the life of the project, the taxable income would be higher. However, this is unlikely to be a serious concern to investors since increases in potential returns in the early years are critical in encouraging investors to take on the risks associated with investment in new rental projects.

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[10] These changes in 'taxable income' do not affect the actual before-tax income (i.e. cash flow) from the project – that is determined by the amount of NOI less the mortgage payments (see Exhibit 2-1). The changes examined here relate to how much of the income from the project is taxable (none in the early years since there is negative taxable income). Equally important is how much *negative* taxable income is generated to the investor; this can be used to reduce income from other sources in determining total income taxes payable by the investor.

Exhibit 4-1:

Effect of Changes in CCA
Illustrative New Rental Project, Toronto

($ per unit)

	'Rent-Up' Year	Year 2	Year 3	Year 4	Year 5	Year 6
Income and Operating Expenses:						
Revenues	10,867	16,626	16,959	17,298	17,644	17,997
Operating Costs	3,900	3,978	4,058	4,139	4,221	4,306
NOI	6,967	12,648	12,901	13,159	13,422	13,691
Current Tax Treatment						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	2,431	4,765	4,575	4,392	4,216	4,047
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	12,495	13,986	13,643	13,297	12,948	11,478
Taxable Income	***(5,529)***	***(1,338)***	***(742)***	***(138)***	***474***	***2,212***
Depreciable Balance:						
Start of Year	121,565	119,134	114,368	109,794	105,402	101,186
CCA	2,431	4,765	4,575	4,392	4,216	4,047
End of Year	119,134	114,368	109,794	105,402	101,186	97,138
5% CCA (with existing half-year rule)						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	3,039	5,926	5,630	5,348	5,081	4,827
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	13,103	15,147	14,698	14,254	13,813	12,258
Taxable Income	***(6,136)***	***(2,499)***	***(1,797)***	***(1,095)***	***(391)***	***1,433***
Depreciable Balance:						
Start of Year	121,565	118,526	112,600	106,970	101,621	96,540
CCA	3,039	5,926	5,630	5,348	5,081	4,827
End of Year	118,526	112,600	106,970	101,621	96,540	91,713
5% CCA (no half-year rule)						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	6,078	5,774	5,486	5,211	4,951	4,703
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	16,142	14,995	14,554	14,117	13,683	12,134
Taxable Income	***(9,175)***	***(2,347)***	***(1,653)***	***(958)***	***(260)***	***1,556***
Depreciable Balance:						
Start of Year	121,565	115,487	109,712	104,227	99,015	94,065
CCA	6,078	5,774	5,486	5,211	4,951	4,703
End of Year	115,487	109,712	104,227	99,015	94,065	89,361

For non-PBCs, as discussed next in Section 4.2, the effects of the increased rate of CCA would be much less since only PBCs are allowed to utilize CCA to create losses for deduction against income from other sources. For non-PBCs, the effect of a higher CCA would be a longer period of zero taxable income from the project, and lower taxable income after that.

US CCA Treatment

Exhibit 4-2 replicates the upper part of Exhibit 4-1, but presents the effect of the US style straight line depreciation (which uses a 27.5 year depreciation period, implying a fixed rate of 3.64 annually).

Adoption of the US CCA rules would have a mixed effect in the early years.[11] In Years 1-3, the loss (i.e. negative taxable income) is less under the US rules than the current Canadian tax treatment. In subsequent years, because CCA is a fixed annual amount (not a percentage of a declining balance as is the case in Canada), the US CCA rules are more favourable – and become ever more favourable as time goes on. By the 20th year, under this US approach, the property will be depreciated by 73%, compared with only 55% in Canada under current rules, or 63% under a 5% CCA rate.

Increasing the CCA rate to 5% would be more beneficial to rental investors than a shift to the US style of CCA treatment – even without any changes to the half-year rule.

Assessment

As noted earlier, the half-year rule and declining balance approach for CCA apply across the Canadian tax system. Changes to these would require a fundamental shift across the system. Accordingly, these options are not considered practical – only an increase in the CCA rate (retaining the half-year rule), which could be implemented solely for new rental housing, is assessed here.

Effectiveness

Increasing the CCA rate would increase the after-tax returns to investors in rental housing – and would, therefore, be an effective way to improve the attractiveness of rental investment. The precise effect would depend on the rate of CCA adopted – the higher the rate, the greater the beneficial impact on rental investment. Most importantly, an increase in the rate of CCA would increase returns in the early years of a rental project, when rates of return are most significant in attracting investment.

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[11] For the purposes here, it is assumed the US project is completed at mid-year in the first tax year – this results in half the normal annual CCA being available for use. If it was completed earlier in the year, more of the normal annual CCA would be available for use (e.g. if it was completed at the end of the first quarter, the CCA deduction would be 75% of the normal annual CCA). Conversely, if it was completed at the end of the third quarter, only 25% of the normal annual CCA could be deducted.

Exhibit 4-2:

Effect of Changes in CCA
Illustrative New Rental Project, Toronto

($ per unit)

	'Rent-Up' Year	Year 2	Year 3	Year 4	Year 5	Year 6
Income and Operating Expenses:						
Revenues	10,867	16,626	16,959	17,298	17,644	17,997
Operating Costs	3,900	3,978	4,058	4,139	4,221	4,306
NOI	6,967	12,648	12,901	13,159	13,422	13,691
Current Tax Treatment						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	2,431	4,765	4,575	4,392	4,216	4,047
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Total Deductions	12,495	13,986	13,643	13,297	12,948	11,478
Taxable Income	***(5,529)***	***(1,338)***	***(742)***	***(138)***	***474***	***2,212***
Depreciable Balance:						
Start of Year	121,565	119,134	114,368	109,794	105,402	101,186
CCA	2,431	4,765	4,575	4,392	4,216	4,047
End of Year	119,134	114,368	109,794	105,402	101,186	97,138
5% CCA (with existing half-year rule)						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	3,039	5,926	5,630	5,348	5,081	4,827
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	13,103	15,147	14,698	14,254	13,813	12,258
Taxable Income	***(6,136)***	***(2,499)***	***(1,797)***	***(1,095)***	***(391)***	***1,433***
Depreciable Balance:						
Start of Year	121,565	118,526	112,600	106,970	101,621	96,540
CCA	3,039	5,926	5,630	5,348	5,081	4,827
End of Year	118,526	112,600	106,970	101,621	96,540	91,713
US Tax Treatment						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	2,212	4,425	4,425	4,425	4,425	4,425
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	12,276	13,646	13,493	13,330	13,157	11,856
Taxable Income	***(5,310)***	***(998)***	***(592)***	***(171)***	***265***	***1,835***
Depreciable Balance:						
Start of Year	121,565	119,353	114,928	110,503	106,078	101,653
CCA	2,212	4,425	4,425	4,425	4,425	4,425
End of Year	119,353	114,928	110,503	106,078	101,653	97,228

Fairness

The federal government accords favourable CCA treatment to other types of capital investments, so there are precedents for more favourable CCA treatment of rental housing. The Urban Development Institute/Ontario points out in its 2001 pre-Budget submission to the federal government[12] that airlines are able to claim CCA of 25% on commercial aircraft – an asset with a life expectancy well beyond what might be inferred from its CCA rate.

Therefore, while the current CCA treatment of rental housing may appear generous since buildings do not typically depreciate at 4% annually (in fact, they generally *appreciate*, or at least do not usually decline significantly in value over time), compared to the CCA allowed for other types of investments (e.g. aircraft), the rate is clearly less generous. Also, significant investments in repairs and capital replacements are necessary to ensure that the building retains its value.

In considering a rate of CCA in excess of actual depreciation, it is important to recognize that, while accelerated depreciation may result in lower tax returns in the short-term, these 'deferred revenues' would be recouped by the government when the asset is sold for more than its depreciated value. Also, while a higher rate of CCA would reduce taxes in the early years of the investment, over time, the depreciable balance would be reduced to the point where actual CCA deductions would be less (and taxes correspondingly higher) than if a lower rate of CCA applies.

The CCA rate of 4% applies to all types of rental real estate (i.e. commercial and industrial buildings), not just rental housing. Previously, different CCA rates were applied to different forms of rental buildings (wood-frame versus concrete) – so it is not unprecedented to vary the CCA rate specific to a particular type of real asset (in this case rental housing).

Practicality

Changing the rate of CCA which applies to rental housing would be a relatively simple change for the federal government to enact. The potential losses in revenue to the federal government could be constrained by restricting the more favourable rate of CCA only to *new rental housing projects*. Without such a restriction, investors purchasing existing rental properties and other types of rental real estate would qualify for the higher CCA rate.

As noted above, it would be far more difficult to change the method associated with CCA depreciation to a straight line (as in the US) or to abolish the half-year rule, as these are features of the Canadian tax system which apply to all capital assets.

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[12] Paul Mondell, Chair, and Neil Rodgers, President, UDI Ontario, *Presentation to the Standing Committee on Finance, 2002 Pre-Budget Consultations "Investing for the Future: The Needs of Urban Regions in Canada"*, October 2001.

4.2. Extension of Eligibility for Use of CCA Losses to All Rental Investors

Background

At present, only PBCs and life insurance companies are allowed to utilize CCA which is in excess of actual net income from a rental project as a deduction against income from other sources in determining their income taxes. Other companies and individuals (or partnerships) can utilize CCA deductions on a rental property only to reduce the net income from this and other rental properties to zero for tax purposes.

The principle involved in restricting the use of CCA from rental properties to create losses from other income appears to be that the benefits of utilizing excess CCA should only apply to those with income from similar types of assets (i.e. rental real estate). The main business of PBCs is real estate so, under this principle, it is appropriate to use CCA losses from one or more of their real estate assets to reduce other income for tax purposes since this other income would also be derived from real estate. Allowing other types of investors (whether companies or individuals) to use CCA losses from real estate against other income would transfer the real estate-related CCA benefits to non-real estate income.

Prior to tax reform in 1972, *all* investors in rental real estate could utilize (the then much more generous) CCA deductions against income from other sources. Subsequent to the elimination of this favourable tax treatment, the federal government established the Multiple Unit Residential Building (MURB) provision of the *Income Tax Act* (1974-1979 and 1980-1981). Investors in certified MURB projects with construction starts in these years could utilize CCA losses from the projects as a deduction against income from other sources.

As discussed in Section 3, the purpose of the MURB provision was to stimulate investor interest in new rental housing projects. In part, the termination of the MURB provision and other measures, such as reductions in CCA (Section 4.1) and changes in soft cost provisions (Section 4.3), were enacted by the federal government to curb aggressive tax shelter arrangements.[13]

In the US, except for small investors within income limits, non-real estate companies cannot utilize losses from rental properties as deductions from income from other sources – this includes *any* losses, not just those related to depreciation. So the Canadian tax treatment of rental housing is more favourable than the US treatment in this regard.

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[13] Arguably, the inefficiency of the former MURB program was a function of the program design. The US similarly tightened advantageous tax rules enacted between 1981-1986, which had supported syndicated rental investment in the US. However, rather than entirely eliminating tax-based incentives for rental investment, they created a new vehicle, the Low Income Housing Tax Credit. This similarly suffered from poor efficiency in its initial years but, over time, refinement to the rules and a competitive market for a limited supply of credit allocations have dramatically enhanced efficiency.

Effect of Extension of Eligibility for Use of CCA Losses

Exhibit 4-3 presents a comparison of the taxable income from the illustrative project for non-PBC investors versus PBC investors – and life insurance companies which also can utilize CCA deductions to create losses for tax purposes. [For simplicity here, companies which can use CCA to create losses are called PBCs, though they also include life insurance companies.] The taxable income for the PBC investor is the same as that shown in Exhibit 2-2 and the 'current tax treatment' part of Exhibits 4-1 and 4-2.

Exhibit 4-3:

Tax Treatment of Non-PBCs
Illustrative New Rental Project, Toronto

($ per unit)

	'Rent-Up' Year	Year 2	Year 3	Year 4	Year 5	Year 6
Income and Operating Expenses:						
Revenues	10,867	16,626	16,959	17,298	17,644	17,997
Operating Costs	3,900	3,978	4,058	4,139	4,221	4,306
NOI	6,967	12,648	12,901	13,159	13,422	13,691
Principal Business Corporations						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	2,431	4,765	4,575	4,392	4,216	4,047
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	12,495	13,986	13,643	13,297	12,948	11,478
Taxable Income	***(5,529)***	***(1,338)***	***(742)***	***(138)***	***474***	***2,212***
Depreciable Balance:						
Start of Year	121,565	119,134	114,368	109,794	105,402	101,186
CCA	2,431	4,765	4,575	4,392	4,216	4,047
End of Year	119,134	114,368	109,794	105,402	101,186	97,138
Other Investors						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	0	3,427	3,833	4,254	4,402	4,226
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	10,064	12,648	12,901	13,159	13,134	11,657
Taxable Income	***(3,097)***	***0***	***0***	***0***	***288***	***2,034***
Depreciable Balance:						
Start of Year	121,565	121,565	118,138	114,305	110,051	105,649
CCA	0	3,427	3,833	4,254	4,402	4,226
End of Year	121,565	118,138	114,305	110,051	105,649	101,423

The differences between the two types of taxpayers illustrated in Exhibit 4-3 include:

- Non-PBC investors have lower tax losses in the rent-up year. Because non-PBCs cannot utilize CCA to create a loss (the project already has a loss before CCA consideration), the $2,431 in CCA deducted by the PBC in the first year cannot be deducted by non-PBC investors. In the case of the illustrative project, zero CCA deductions are allowed for non-PBCs in the first year.

- In Years 2-5, non-PBCs can only use CCA to reduce taxable income (the difference between NOI and interest and other deductions) to zero, so the project generates no taxable income – the non-PBC cannot utilize the full CCA available since that would result in a loss. In comparison, the PBC can generate losses for tax purposes throughout this period.

- In subsequent years, the taxable income from the two types of investors is similar. In fact, the non-PBC has lower taxable income than the PBC in Years 5+ because the non-PBC's depreciable balance is higher (since less CCA was deducted in the early years).

In terms of the use of CCA deductions, the main difference between the two types of investors is in the early years of an investment. Once NOI minus interest payments exceeds the available CCA, there is no difference between PBCs and non-PBCs in terms of CCA.

Assessment

Effectiveness

Extending eligibility to deduct CCA losses against income from other sources would not affect the attractiveness of rental investment for PBCs. As discussed in Section 3, PBCs are considered the most likely potential investors in new rental housing since they have the knowledge and expertise required.

Exhibit 4-3 shows that there would be an improvement in the attractiveness of investment in rental housing for non-PBCs if they could utilize CCA losses against other income. The main potential non-PBC investors would be high-income individuals who could utilize CCA losses to reduce taxes on income from other sources. As discussed in Section 3, few individuals have the expertise or financial capacity to develop new rental projects. Therefore, the only way for this measure to be effective in stimulating new rental construction would appear to be if it encouraged the formation of syndicated tax shelters which would combine the expertise of the syndicator (in organizing the tax shelter and developing the project) and the financial resources of high-income individuals seeking to shelter income from taxes.

With the reduction in personal income tax rates in recent years, the attractiveness of tax shelters has been reduced. However, for high-income individuals, marginal tax rates still approach 50% and the potential to reduce taxes is still strong. Use of CCA losses on real estate investments would be attractive to some investors. How attractive would depend on the actual tax benefits which accrue to the investor – which would depend not only on the costs and revenues associated

with the rental project, but also the size and nature of the syndication and other fees, and other inducements such as cash-flow guarantees, etc.

The analysis in Exhibit 4-3 may understate the potential tax advantages which would accrue to investors if this measure were allowed: tax shelter syndicators have, in the past, proved to be very innovative in structuring investment vehicles to utilize CCA losses (and other features) to encourage high-income individuals to shelter income from other sources from taxes. It seems likely (or at least possible) that a new form of tax-based program (possibly a tax credit program), or simply allowing all investors to utilize CCA losses from rental projects against other income would generate interest in such tax shelters – and hence stimulate new rental housing development. With careful program design, the inefficiency and leakage of past MURB type programs could conceivably be avoided.

Fairness

The justification for the restriction on the use of excess CCA to PBCs appears to be based on the premise that the benefits associated with utilizing CCA on real property should only be applied to income from that property or other real property. This premise appears to be breached in the case of life insurance companies; however, no other types of taxpayers are allowed to utilize CCA from real property as deductions against income from other sources.

Practicality

Extending eligibility to deduct CCA losses from other income to *all* investors would not be difficult to implement; however, the potential losses in government revenue could be significant, unless the measure is restricted only to *new rental housing projects* – for example, Labour Sponsored Investment Fund tax credits influence investment behaviour and provide an incentive to investors, but cap the level of credits issued and target the proceeds only to 'eligible investments'. Without such a restriction, high-income investors purchasing existing rental properties and other types of rental real estate could qualify for the use of CCA losses – with corresponding reductions in taxes payable to the government.

To the extent that the federal tax system has progressively moved away from tax stimulus (disentangling the tax system from policy and program priorities), there may be some resistance to this type of measure.

4.3. Restoration of Soft Cost Deductibility

Background

'Soft costs' are expenses related to the period during construction of a building. They include costs such as landscaping, legal and accounting fees, building permit and development fees and levies, mortgage and mortgage insurance application fees and premiums, professional fees for architects and engineers, interest on construction financing, and property taxes payable during construction – among other things.

Prior to 1979, investors in rental properties could deduct defined types of soft costs as an expense in determining income for tax purposes. The availability of soft cost deductions were an important feature of the MURB tax shelter syndications which were offered to high-income investors during this period. In 1979 and 1981, the federal government introduced changes which effectively terminated the immediate deductibility of soft costs for non-PBCs:

- In 1979, deductions for some soft costs were restricted to the year to which they related. This change modestly reduced the attractiveness of several types of soft costs – e.g. cash flow guarantees for tax shelter rental projects;
- In 1981, soft costs incurred by non-PBCs were required to be capitalized into the value of the building and depreciated over time.

These changes were introduced as part of the effort to curb the aggressive rental tax shelter syndications for high-income investors discussed in Section 3.[14]

Initially, the rules requiring the capitalization of soft costs did not apply to PBCs; however, this changed in 1988 with the phase-in of similar requirements. Since 1992, all investors in rental properties (including rental housing and other types of rental real estate) must capitalize soft costs incurred in the construction or renovation of rental projects. As discussed in Section 2, only a few costs incurred in the development and financing of new rental housing projects are now deductible (rather than capitalized and depreciated over time) – e.g. landscaping costs and mortgage insurance fees.

In the US, the income tax treatment of soft costs is similar to Canada – soft costs are added to the capitalized cost of the property and depreciated over time.

Effect of Restoring Deductibility of Soft Costs

Exhibit 4-4 demonstrates the effect of restoring deductibility for soft costs for rental investors. For the purposes of illustration, immediately deductible soft costs of $5,000 are assumed – the actual amount would depend on the precise definition of which types of soft costs would be eligible for deduction.[15]

The $5,000 deduction for soft costs in the first year raises the negative taxable income to $10,429 – slightly less than $5,000 more than the $5,529 in negative income under the current tax treatment. CCA is, of course, slightly reduced compared to the current tax treatment because the depreciable balance is reduced by the amount of the soft costs. In future years, the project would generate marginally more taxable income than under the current tax treatment because of slightly lower CCA deductions.

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[14] As discussed in Section 4.2, these syndications also typically involved the use of CCA deductions against income from other sources. However, depending on the level of soft cost deductions allowed, it might be possible to structure a tax shelter syndication without the CCA tax benefits – i.e. relying on the soft cost deductions alone.

[15] In fact, during the 1970s, deductible soft costs included a variety of items (e.g. interest and property taxes during construction, levies, legal fees, etc.) which would total much more than $5,000. The $5,000 figure is used here to illustrate the effect of a moderate relaxation of the current rules regarding immediately deductible soft costs, not necessarily a return to soft cost rules which prevailed in the 1970s.

To the extent that the tax losses created in the first year can be utilized to reduce taxable income from other sources, the soft cost deductions would be highly beneficial to investors in rental housing – particularly those with high incomes from other sources. Assuming the illustrative building had 200 units, the $10,429 'loss' in the first year (Exhibit 4-4 with the soft cost deductions) would result in deductions from other income of almost $2.1 million.

If combined with other measures, such as a higher CCA or allowing all investors to utilize both CCA and soft cost deductions, the attractiveness of rental housing investment would be even greater.

Exhibit 4-4:

Effect of Soft Cost Deductibility
Illustrative New Rental Project, Toronto

($ per unit)

	'Rent-Up' Year	Year 2	Year 3	Year 4	Year 5	Year 6
Income and Operating Expenses:						
Revenues	10,867	16,626	16,959	17,298	17,644	17,997
Operating Costs	3,900	3,978	4,058	4,139	4,221	4,306
NOI	6,967	12,648	12,901	13,159	13,422	13,691
Current Tax Treatment						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	2,431	4,765	4,575	4,392	4,216	4,047
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	12,495	13,986	13,643	13,297	12,948	11,478
Taxable Income	***(5,529)***	***(1,338)***	***(742)***	***(138)***	***474***	***2,212***
Depreciable Balance:						
Start of Year	121,565	119,134	114,368	109,794	105,402	101,186
CCA	2,431	4,765	4,575	4,392	4,216	4,047
End of Year	119,134	114,368	109,794	105,402	101,186	97,138
With Soft Costs Deductions						
Deductions:						
Interest	8,248	8,105	7,952	7,789	7,616	7,431
CCA	2,331	4,569	4,387	4,211	4,043	3,881
Soft Costs	5,000					
Landscaping	700					
Mort. Ins. Fee	1,116	1,116	1,116	1,116	1,116	
Total Deductions	17,395	13,790	13,455	13,116	12,775	11,312
Taxable Income	***(10,429)***	***(1,142)***	***(554)***	***43***	***648***	***2,379***
Depreciable Balance:						
Start of Year	116,565	114,234	109,664	105,278	101,067	97,024
CCA	2,331	4,569	4,387	4,211	4,043	3,881
End of Year	114,234	109,664	105,278	101,067	97,024	93,143

Assessment

Effectiveness

Restoring investors' ability to deduct soft costs up-front, rather than capitalize them and depreciate them over time, would clearly enhance the potential after-tax returns to investors. This would be beneficial to PBCs investing in new rental projects – the key target group if the rental housing industry is to be revitalized.

To the extent that the restoration of soft cost deductibility might generate interest in syndicated rental investment tax shelters, this measure could also encourage participation by individual investors. The potential for tax shelters would be enhanced further if CCA benefits (see Section 4.2) were provided as well. As with the MURBs in the 1970s and 1980s, more favourable tax treatment of rental housing would likely be very attractive to potential investors. Such tax shelters could also be acceptable to the federal government if they were part of a carefully designed and well targeted program.

Fairness

Currently, there are no apparent inequities in the treatment of soft costs – all forms of real estate are subject to the same treatment.

Practicality

Restoring soft cost deductibility would not be difficult to implement; however, as with the CCA provisions, the potential losses in government revenue could be significant, unless the measure is restricted only to new *housing* projects. Without such a restriction, investors in other types of commercial or industrial real estate would qualify for the use of soft cost deductions on new rental properties.

4.4. Deferral of Capital Gains Tax and Recaptured CCA Upon Reinvestment in Rental Housing

Background

The key objective of this potential change is to increase liquidity and reinvestment in the rental sector. Currently, when an investor in a rental housing project (or any other type of rental real estate) sells the project, taxes are payable if the sale price exceeds the depreciated value of the project. The taxes would be based on a combination of recaptured depreciation and capital gains. The taxes payable as a result of recaptured depreciation and capital gains act as a deterrent to selling – the investor would prefer to keep the project (and avoid the taxes) rather than sell and reinvest in another project. In the extreme, where permitted, owners may resort to demolishing an existing property to avoid the tax consequences of recapture – this would result in the destruction of older properties providing relatively affordable rental units.

The situation for the investor is best illustrated through an example: Exhibit 4-5 presents the case of a 100 unit rental project completed in 1978 for a total cost of $50,000 per unit ($5 million for the total property) and sold in 2001 at a price of $80,000 per unit ($8 million in total). The data in the exhibit are on a *per unit* basis.

Exhibit 4-5:

Sale of an Existing Rental Property

($ per unit)

	Initial Cost (1978)	Deductions (1978-2000)	Depreciated Value (2001)	Sale Price (2001)	Difference
Land	5,000	0	5,000	15,000	10,000
Soft Costs	5,000	5,000			
Depreciable Asset	40,000	27,060	12,940	65,000	52,060*
Total	50,000	32,060	17,940	80,000	62,060

* $27,060 in recaptured depreciation and $25,000 in capital gains on the building

Key elements of the exhibit include:

- The breakdown of initial costs into land ($5,000 per unit), soft costs ($5,000) and depreciable costs ($40,000) is important to the analysis: land is not a depreciable asset; soft costs were immediately deductible in 1978; and CCA of 5%[16] of depreciable costs could be charged against income every year.

- By year-end 2000, the depreciated value of the project would be roughly $17,940 per unit – the net depreciated building value of $12,940, plus the initial land cost ($5,000). The CCA deductions would have totalled roughly $27,060 over the 1978-2000 period.

- The tax consequences of the sale in 2001 would comprise a combination of recaptured depreciation (which is fully taxable as income) plus capital gains (50% of which is added to income for tax purposes). Therefore, the $62,060 difference between the sale price ($80,000) and the depreciated value ($17,940) would be comprised of $27,060 in recaptured depreciation (the amount deducted over the years) and $35,000 in capital gains ($10,000 on the land and $25,000 on the building).

- Since only 50% of capital gains are taxed, the increase in taxable income for the investor would be $44,560 per unit ($27,060 + $35,000/2). This is a substantial sum: for a 100 unit building, the increase in taxable income for the investor would be $4,456,000.

- For an Ontario-based corporation, the taxes payable on the $4,456,000 in gains from the sale would total $1,876,867 – comprised of $1,253,027 (28.12%) in federal corporate

[16] While, as discussed in Section 4.1, the CCA rate for rental buildings was reduced to 4% in 1988, the 5% rate continued to apply to buildings acquired in previous years.

taxes, and $623,840 (14%) in Ontario corporate taxes. Thus, after removing taxes, about $6.1 million of the $8 million in proceeds from the sale (less any financing on the project) would be available to reinvest in other ventures.

The taxes payable are a significant disincentive for rental investors to sell their rental projects. It is a feature of the tax system which reduces liquidity in the industry since it hampers turnover of rental projects – developers who build and hold projects for an extended period are discouraged from selling them (even in a favourable sales climate such as the present) because of the significant taxes payable. Therefore, many investors simply retain their current rental buildings, rather than upgrade their portfolios by selling some buildings and reinvesting the proceeds in other rental properties.

Prior to tax reform in 1972, the sale of a rental property could be undertaken without tax being payable (in terms of recaptured depreciation) *if the proceeds were reinvested in another rental property.*[17] This is a critically important feature of the changed tax environment for rental housing. The restoration of tax-deferred roll-over of rental properties would postpone the tax liability on recaptured depreciation (and capital gains) for owners of rental properties who invested the proceeds in another rental property. This would be beneficial to investment in new rental projects since it would encourage owners of older, heavily depreciated projects to upgrade their rental property portfolios by replacing older projects with newer ones – and provide them with much greater equity for the investment ($8 million versus $6.1 million in the above example). The taxes payable on recaptured depreciation and capital gains would be deferred as long as investors retained the newly-acquired rental projects – in the same way that these taxes are currently postponed as long as investors retain ownership of their current projects.

Unlike the case with rental properties, businesses investing in other types of capital can defer recaptured depreciation and capital gains if they acquire a replacement property of equal or greater value. For example, a company replacing a building occupied by its business can defer recaptured depreciation and capital gains tax if it acquires another building of equal or greater value. Similarly, a company can defer recapture of depreciation and capital gains on capital equipment sold if other assets of the same type are purchased as a replacement – e.g. if the airliner with the 25% CCA (discussed in Section 4.1) is sold for more than the depreciated cost, the recaptured depreciation and capital gains can be deferred if the airline purchases another aircraft. So, rental properties (including both rental housing and other types of rental real estate) are treated differently from other types of capital properties in this regard.

In the US, the tax treatment of the sale of a rental property is quite different from the Canadian situation (discussed above). In the US, rental housing investors can defer capital gains tax and recaptured depreciation if the property is replaced by another property of greater or equal value.

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[17] Prior to 1972, investors could 'pool' a portfolio of rental buildings for the purposes of CCA, so recaptured depreciation on the sale of a building could be deferred by deducting the amount of the recaptured depreciation from the remaining undepreciated balances of the remaining buildings in the pool. If the recaptured depreciation was greater than the undepreciated balances, tax would have to be paid, unless another building was purchased.

Effect of Deferral of Capital Gains Tax and Recaptured Depreciation

Many existing rental properties are owned by investors who have held them for a significant period. In many cases, these investors developed the buildings in the first place. They know the risks associated with rental development and might be encouraged to develop new rental projects – if the incentives are right. Many would have land holdings which might be suitable for rental development. However, as discussed, if they attempt to redeploy capital from their existing rental portfolio to developing a new rental project, they will suffer substantial tax consequences – a significant disincentive to sell their older projects and build new ones. If taxation of capital gains and recaptured depreciation could be deferred when a building is sold *providing the funds were reinvested in another rental project*, it seems likely that many of these investors could be encouraged to develop new rental projects.

There would be a ready market for the 'supply' of older rental projects which might result from the restoration of tax-deferred roll-over. Long-term investors, such as pension funds and REITs, have been very active in purchasing existing rental projects over the past several years. These investors are attracted to the stable cash flow that comes from an established rental project – they find the risks associated with a newer project less attractive. Similarly, non-profit providers seeking to expand their portfolio of rental housing could purchase existing rental buildings at a fraction of the cost of building new projects. However, there has been a shortage of existing rental projects for sale because of the combination of strong demand and the fact that the owners of these older (heavily depreciated) rental buildings are reluctant to sell because of the taxes.

Another consideration in support of deferral is the perverse impact of the existing system of CCA recapture in influencing decisions to demolish much-needed older (more affordable) existing rental housing. Given the significant capital gain and recapture tax liability in cases of older rental properties in locations with high land values, it may be more advantageous for property owners to demolish the building and rebuild on the same site. Demolition triggers a terminal loss and eliminates the tax liability. While a replacement development may occur, it may not be rental accommodation – instead, an existing relatively affordable rental property could be demolished and replaced with (for example) luxury condominiums.

Assessment

Effectiveness

Deferral of capital gains tax and recaptured depreciation on the sale of a rental building, providing the proceeds are invested in another rental building of greater or equal value, would help to 'unlock' the current situation where there is a lack of net new investment in rental housing. While there is a substantial pool of new capital seeking to invest in rental housing, the new capital is attracted mainly to existing properties with stabilized cash flow. This stock is held by investors who are reluctant to sell because of the significant tax consequences.

If they could dispose of their current holdings and defer the tax consequences, on the condition that they reinvest the proceeds in rental housing, current investors in existing rental projects

might be encouraged to sell and to develop new projects. These investors know rental housing – they know the risks and the potential rewards. They are typically more prepared to take the risks associated with the development of new rental projects than institutional investors. Allowing them to defer the taxes associated with the redeployment of their capital from an existing project to another rental project would likely stimulate significant interest in new rental investment.

Permitting the deferral of tax liability could also help to reduce perverse incentives that, in the extreme, result in the demolition and loss of existing relatively affordable rental stock.

Fairness

In requiring that recaptured depreciation and capital gains be taxed upon the sale of rental property, the federal government treats rental property differently to most other types of capital assets – in general, investors can defer recaptured depreciation and capital gains on assets if more assets of the same type are purchased during that year. Thus, there is a strong equity argument in favour of considering deferral of recaptured depreciation and capital gains on the sale of rental housing projects, providing the proceeds are reinvested in another rental project.

Practicality

Deferral of recaptured depreciation and capital gains tax would be relatively simple to implement – the same provisions are provided for most types of capital assets, and such deferral is currently allowed in the US. If considered desirable, the measure could be restricted to investment in rental housing – rather than extending it to other types of real estate.

It is important to emphasize that this potential measure relates to *deferral* (not forgiveness) of capital gains tax and recaptured depreciation – and, that the deferral is contingent on the reinvestment of the proceeds in another rental project of greater or equal value. The tax liability would be transferred to the new project so there would be no ultimate loss of taxes for the government. At present, investors in heavily depreciated rental projects are reluctant to sell so there is limited tax flowing to the government from such sales in any case.

4.5. Allowing Small Landlords to Qualify as Small Businesses

Background

Most investors in rental properties are small investors – individuals or small partnerships – who own only one or two units, or a small apartment building. These small investors account for a significant portion of the rental housing stock, though there is no recent information on their share of the total stock. Unless they are incorporated, rental income to these types of investors is taxed as part of their personal income – at personal income tax rates.

Corporations which own rental housing pay corporate income tax on their income from these properties. The tax treatment of corporations is complex. For the purposes of taxing income

from rental properties, the *Income Tax Act* makes a distinction between *active* and *passive* income. In general, according to the *Act*:

- An *active* business means any business carried out by a corporation other than "a specified investment business or a personal service business". Personal service businesses are not relevant to this report; however, 'specified investment businesses' are.

- According to the *Act*, a 'specified investment business' means a corporation with a principal purpose of deriving income (including interest, dividends, rents and royalties) from property (including *real property* (e.g. rental real estate), as well as other types of property such as stocks, bonds, mutual fund investments, limited partnerships, etc.) – except for companies with more than 5 full-time employees. Therefore, a company in the business of renting out real estate is not an *active* business unless it has more than 5 full-time employees.

For most types of small corporations, a lower rate of taxation applies to the first $200,000 of 'active business income' – called the small business deduction.[18] This is illustrated in Exhibit 4-6 which presents the basic federal, Ontario and combined corporate tax rates for the 2001-2005 period, as well as the small business corporate tax rates, and the special tax rates which apply to 'passive business income'.

Exhibit 4-6:

Federal and Provincial Corporate Tax Rates

2001-2005

	2001	2002	2003	2004	2005
Basic Corporate Rate					
Federal	28.12%	26.12%	24.12%	22.12%	22.12%
Ontario	14.00%	12.50%	11.00%	9.50%	8.00%
Combined	42.12%	38.62%	35.12%	31.62%	30.12%
Small Business Tax Rate					
Federal	13.12%	13.12%	13.12%	13.12%	13.12%
Ontario	6.50%	6.00%	5.50%	5.00%	4.00%
Combined	19.62%	19.12%	18.62%	18.12%	17.12%
'Passive Income' Tax Rate					
Federal	35.79%	35.79%	35.79%	35.79%	35.79%
Ontario	14.00%	12.50%	11.00%	9.50%	8.00%
Combined	49.79%	48.29%	46.79%	45.29%	43.79%

The combined federal/Ontario corporate tax rate for small businesses in 2001 was 19.62%, and is scheduled to decline modestly to 17.12% in 2005, because of a reduction in the Ontario tax rate

[18] For Ontario corporate taxes, the threshold for the small business deduction is being raised in progressive stages to $400,000 over the next several years. For 2001, the small business deduction applies to income of $240,000 or less.

for small businesses. The basic combined corporate tax rate (the tax rate for most corporations) was more than double the rate for small businesses in 2001 – 42.12%, and scheduled to decline to 30.12% in 2005. Therefore, the differential between the two rates will narrow somewhat over the next few years – from 22.50% in 2001, to 13.00% in 2005.

The tax rate for 'passive business income' is much higher than the basic corporate tax rate or the small business rate – 49.79% in 2001[19] compared to 42.12% (basic corporate tax) and 19.62% (small business). The higher tax rate for 'passive business income' results from higher federal taxes; the Ontario rate is the same as the basic corporate rate. The 'passive income' tax rate will decline somewhat over the next few years (due to lower Ontario tax rates); however, the gap between this rate and both the basic corporate tax rate and the small business tax rate will widen significantly by 2005.

Tax Treatment of Small Corporate Landlords

As discussed above, small companies with rental properties have been specifically excluded from qualifying for the (lower) small business tax rate. To qualify as a 'small business', the *Income Tax Act* specifies that a company must have both:

- 'Active business income' – unless the company is a PBC, rental income is considered 'passive' (whether the owner engages in the hands-on management of the business or not); and
- To qualify as an 'active' business, a PBC must have *6 or more full-time employees*.

Because of this restrictive definition, few (if any) of the small rental companies in Canada would qualify for the favourable tax treatment which is available to most small businesses. For example, companies with a small apartment building might qualify as a PBC; however, in most cases, they would not have a sufficient number of employees. With total operating costs of $2,000 per unit annually for the illustrative rental project (including all types of costs, not just the cost of employees), it seems clear that a company with 6 or more full-time employees would not be considered a small landlord by most common definitions of the term.

The restrictive definitions for the small business deduction appear to be a deliberate action by the federal government to discourage small investors in rental housing from establishing companies – and thereby qualifying for the small business tax rate, and the tax deferral advantages associated with incorporation. Instead, their corporate taxes are not only higher than for other small businesses, but because their income is considered 'passive', their taxes are higher than for PBCs and other types of businesses (which qualify for the basic corporate tax rate).

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[19] There is feature of the federal tax treatment of 'passive income' whereby approximately 27% of the taxes are refundable to the company when it pays dividends to shareholders (at the rate of $1 of refund for each $3 of dividends). Depending on the personal income tax rate of the shareholder, the taxes collected through personal income taxes on the dividends likely effectively replace the taxes refunded through this mechanism.

Effect of Extending the Small Business Deduction to Small Rental Landlords

Exhibit 4-7 presents estimates of the corporate taxes payable by three different investors in a rental project:

- An investor paying the 'passive business income' tax rate;
- An investor paying the basic corporate tax rate; and
- An investor eligible for the small business deduction.

Exhibit 4-7:

Corporate Taxes Payable on Rental Income

2001-2005

	2001	2002	2003	2004	2005
Taxable Income	$100,000	$102,000	$104,040	$106,121	$108,243
Taxes Payable:					
'Passive Income' Tax Rate	49.79%	48.29%	46.79%	45.29%	43.79%
Taxes Payable	$49,790	$49,256	$48,680	$48,062	$47,400
Basic Corporate Tax Rate	42.12%	38.62%	35.12%	31.62%	30.12%
Taxes Payable	$42,120	$39,392	$36,539	$33,555	$32,603
Small Business Tax Rate	19.62%	19.12%	18.62%	18.12%	17.12%
Taxes Payable	$19,620	$19,502	$19,372	$19,229	$18,531
'Passive Income' Taxes as % of Small Business Taxes	253.8%	252.6%	251.3%	249.9%	255.8%
'Passive Income' Taxes as % of Basic Corporate Rax Rate	118.2%	125.0%	133.2%	143.2%	145.4%
After-Tax Return on $1Million Investment:					
'Passive Income' Tax Rate					
After Tax Income	$50,210	$52,744	$55,360	$58,059	$60,844
Return on Investment	5.02%	5.27%	5.54%	5.81%	6.08%
Basic Corporate Tax Rate					
After Tax Income	$57,880	$62,608	$67,501	$72,565	$75,640
Return on Investment	5.79%	6.26%	6.75%	7.26%	7.56%
Small Business Tax Rate					
After Tax Income	$80,380	$82,498	$84,668	$86,892	$89,712
Return on Investment	8.04%	8.25%	8.47%	8.69%	8.97%

For the purposes here, it is assumed that the rental property is generating $100,000 in taxable income in 2001 and that taxable income rises by 2% annually in each subsequent year. The exhibit also presents the after-tax income and the after-tax return on investment from the rental

property for the three taxpayers (assuming an initial investment of $1 million). Key features of this analysis include:

- In 2001, the taxes payable on $100,000 in rental income for the 'passive' investor would be $49,790 – 18% above the taxes payable at the basic corporate rate, and 154% more than the $19,620 which would be payable if the company qualified for the small business tax rate.

- Because of the planned reduction in corporate tax rates, the taxes payable for 'passive' investors decline over the next several years. By 2005, the taxes payable on the (higher) taxable income generated that year are slightly lower – $47,400, compared to $49,790 in 2001. This decline is very modest compared to the planned decline in basic corporate taxes – from $42,120 in 2001 to $32,603 in 2005.

- The taxes payable if the investor paid the small business rate also decline over the period – due to reductions in the Ontario small business corporate tax rate. By 2005, the taxes payable would decline to $18,531.

- The gap between the taxes payable by a 'passive' investor compared to investors eligible for the small business tax rate actually rise slightly over the 2001-2005 period from 154% to 156%. Compared to companies paying the basic corporate rate, 'passive' investors taxes rise from 18% higher in 2001 to 45% higher in 2005.

- Assuming the investor's initial investment was $1 million, the after-tax return in 2001 would be 5.02% for 'passive' investors, 5.79% for companies subject to the basic corporate tax rate, and 8.04% for companies eligible for the small business rate. By 2005, the rates of after-tax return would be 6.08% ('passive' investor), 7.56% (basic corporate rate) and 8.97% (small business).

Clearly, there would be substantial benefits to rental investors if they could be eligible for the small business deduction. The reduction in corporate taxes would make the after-tax return from an investment in rental property significantly more attractive.

Assessment

Effectiveness

Extending eligibility for the small business deduction to small landlords would certainly enhance the returns to investment in rental housing for small corporate investors – and, therefore, would make such an investment more attractive. Given the importance of small investors as providers of rental housing, this would likely stimulate investor interest in acquiring rental projects.

As discussed, most small investors typically purchase small existing properties (e.g. houses, or single units in a condominium) – these are individuals and would not likely be affected by such a change, which would only apply to corporations. For corporate investors, owning an apartment building would become significantly more attractive if they could qualify for the small business

tax rate. Since they lack the expertise and capital to develop and build new projects, they typically would be more interested in an existing project than developing a new one. So, while eligibility for the small business deduction would increase interest in rental housing investment, in terms of the key question in this analysis (would it result in increased new rental production), this measure would not likely be as effective as many of the others under consideration here.

Fairness

The *Income Tax Act* specifically requires 'active business income' in order for a corporation to qualify for the small business tax rate. If a company does nothing but rent real estate, its business is considered to be 'passive' – unless it has more than 5 employees – so it does not qualify for the favourable rate which applies to other types of small businesses (including such businesses as hotels and motels). For tax purposes, income to corporations from rental properties is treated the same as income from corporations which invest only in stocks, bonds, and mutual funds, etc. – i.e. income for which no significant effort is required in terms of day-to-day management of the asset.

Rental housing is very different from investments in stocks, bonds and mutual funds. Rental properties require hands-on day-to-day management – insurance, utilities, and property taxes must be paid; units must be advertised; tenants screened; cheques collected and deposited; arrears pursued; tenants evicted in the case of non-payment or other problems; and buildings and open spaces must be cleaned, maintained, repaired and upgraded. Rental housing requires much more effort on the part of the investor/owner than other types of 'passive' investments.

In terms of equity, rental businesses are treated differently from other types of businesses which require hands-on management. Such businesses qualify for the small business deduction; those involved in rental real estate are specifically excluded from qualifying for this favourable rate.

Practicality

Extending the small business deduction to rental businesses would not be difficult to implement – it would simply require that income from corporate owners of rental properties be treated the same as income from other types of corporations. However, more complex procedures would be required if the benefits were to be targeted specifically at investments in *new* rental housing.

The key concern of the federal government with respect to this measure would likely be that it might encourage individuals and partnerships owning rental properties to incorporate in order to obtain the more favourable tax treatment available to corporations. The majority of the rental stock in Canada is owned by small investors with only one or two units, or one or two small apartment buildings – most of these investors are individuals or unincorporated businesses which include rental income as part of their personal income for tax purposes. Incorporation would allow these investors not only to qualify for corporate tax rates, it would also allow them to defer paying personal income taxes on the income from their investment to years when their income from other sources might be less. At present, incorporation is unlikely to be financially attractive for many of these small investors, given the costs involved. However, access to the small business tax rate might encourage more investors to incorporate – with resulting reductions in revenue for the government.

4.6. Eliminating the Capital Tax on Rental Housing

Background

Both the federal and provincial governments levy capital taxes on large corporations – including companies investing in real estate:

- The federal Large Corporation Tax (LCT) levies a tax of 0.225% on taxable capital in excess of $10 million. For profitable corporations, corporate income taxes can be used as a credit to reduce the LCT – so, for profitable corporations, no LCT may be payable.
- The Ontario Capital Tax was 0.3% of taxable capital for corporations with taxable capital of $3.2 million in 2001. No capital taxes applied for taxable capital below $2 million; there was a graduated rate for taxable capital between $2 million and $3.2 million; the rate of 0.3% applied to taxable capital in excess of $3.2 million. In 2002, the threshold rose to $5 million, so the 0.3% rate applies to taxable capital in excess of $5 million.

'Taxable capital' is the total capital employed by the business – i.e. in addition to shareholders' equity, it includes corporate financing through loans and mortgages. For a rental project, the taxable capital would essentially include the long-term financing (mortgage loans), owner's equity, and retained earnings. Therefore, if a corporation has taxable capital of $10 million, both federal and provincial capital tax would be payable – at a combined rate of 0.525%. In the rental housing business, $10 million is not a great deal of taxable capital, so most corporations with apartment buildings would face capital taxes.

Most other provinces in Canada and some states in the US also have capital taxes. There is no federal government capital tax in the US.

Capital taxes are controversial. In a recent appearance before the House of Commons Finance Committee, a group called the Coalition for the Elimination of Capital Taxes (CECT) argued that elimination of the capital tax would encourage new investment, create jobs, and remove the tax bias against capital-intensive industries:

> "It is important that government take measures that help business grow and invest in the future of Canadians. Capital taxes are applied regardless of the economic cycle and actually discourage investment and job creation when it is most needed."[20]

The CECT noted that Alberta, BC and Ontario all are in the process of reducing or eliminating capital taxes. The 2001 Ontario Budget announced the intention of the Province to reduce the capital tax by introducing a capital tax deduction for the first $5 million of taxable capital. As noted in the Budget document:

> "The capital tax discourages investment in capital, when more capital per worker is what is needed to boost productivity and standards of living. The capital tax is unrelated to

[20] Coalition for the Elimination of Capital Taxes, *Capital Taxes Kill Jobs and Investment*, notes from an appearance before the House of Commons Finance Committee, October 31 2001.

> profits, making it a fixed cost of business ... The Business Tax Review Panel noted that, on an international basis, Canada is almost unique in having capital taxes. The Panel believed that the capital tax serves as a deterrent to attracting international investment."[21]

Effect of Eliminating Capital Tax

Elimination of the capital tax would reduce the taxes payable by the corporation. For example, the illustrative 200 unit building used for this analysis would, in the first year, be considered to have taxable capital in excess of $30 million (investor's equity of $23,763 per unit, plus the mortgage of $129,580 – including the mortgage insurance fee). Therefore, assuming the company already had capital in excess of the federal and provincial thresholds, the combined federal and provincial capital taxes on this building would be over $160,000 – or $800 per unit.

Assessment

Effectiveness

As discussed, elimination of capital taxes would clearly improve the after-tax return on an investment in rental housing. However, it should be borne in mind that elimination of capital taxes would result in a similar improvement in the returns from other types of capital investments. Therefore, it would not necessarily improve the *relative* attractiveness of investment in rental properties, compared to alternative investments – unless the measure related only to investments in rental housing.

As indicated above, a corporation currently liable for capital tax would face capital taxes of roughly $800 per unit in the first year for the illustrative rental project. Given the very marginal cash flows and levels of return in the early years, capital taxes contribute to and exacerbate an already unfavourable investment environment.

Fairness

Capital taxes apply to all types of capital investments – not just rental housing. There does not appear to be an equity argument for removing capital taxes on rental housing.

Practicality

Governments appear to be moving towards elimination of capital taxes for reasons of economic efficiency – unrelated to the rental housing situation. While capital taxes clearly reduce the attractiveness of rental investment, it seems likely that debate about their elimination will revolve around issues that are unrelated to the need to encourage rental housing investment.

Elimination of capital tax would be relatively easy to implement if governments chose to do so. Alternatively, the measure could fairly easily be targeted to benefit rental housing exclusively by eliminating rental housing from capital taxes and retaining the tax for other types of capital.

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[21] 2001 Ontario Budget, Budget Papers, *Responsible Choices*, May 9, 2001, page 89.

4.7. Full Rebates or Zero-Rating of Rental Housing for the GST

Background

The GST was introduced in 1991 to replace the previous federal manufacturers sales tax (FST). For building materials, the rate of FST was 5% during the 1974-1983 period, 6% in 1984-1985 and 8% in 1986-1989 before being raised to 9% in 1990, the year prior to the introduction of the GST. While the FST applied to the value of manufactured goods at the *factory gate* (i.e. excluding transportation costs and wholesale/retail margins), the GST applies to the *final price* of goods and services.

Until 2000, the full 7% GST was payable on the value of a new rental building at completion. Rental housing did not qualify for the rebate of 36% of GST which was available for *new ownership* housing.[22] In the 2000 Federal Budget, the rebate was extended to include rental housing as well – so, effectively, the GST payable on new rental developments is now 4.5% [i.e. 7% - (36/100 x 7%) = 4.48%].

The federal sales taxes collected on new housing through the GST are much greater than those collected prior to 1991 with the FST – even disregarding the increase in the FST in 1990. An analysis completed in 1995 indicated that the GST payable on new rental housing was roughly 3 times the amount which was collected under the 9% FST[23] – now, with the recently-introduced rebate, this gap would be reduced to roughly twice the level of sales taxes collected on rental housing by the FST. While the federal Department of Finance apparently believes that the rebate is sufficient to roughly equate the levels of federal sales taxes collected on new housing with those which applied prior to the introduction of the GST, this is clearly not the case. As the Canadian Home Builders' Association (CHBA) indicates in its 2001 Pre-Budget Submission:

> "For the effective rate of FST to approximate 4.5% of the value of a new home, the value of building materials in that home would have had to account for over half the price of the home – i.e. for 9% of a component of the home (in this case, building materials) to be equivalent to 4.5% of the full price of the home, that component would have to be equivalent to half the price of a home."[24]

Building materials do not account for anywhere near half the price of a home – especially the value of these materials *at the factory gate*, the base for the FST. The actual amount of FST collected on the materials used in new housing is estimated to have been roughly 2.1-3.1% of the total value of a new home – depending mainly on the cost of land. In centres with high land costs, the FST would have accounted for less than 2.5% of the price of a dwelling. This is well below the 4.5% currently collected on new housing with the GST.

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[22] The rebate is phased out for new dwellings priced at $350,000 per unit or more. Dwellings priced at $450,000 or more are subject to the full 7% GST.

[23] *The Challenge of Encouraging Investment in New Rental Housing in Ontario*, prepared by Greg Lampert for the Ontario Ministry of Municipal Affairs and Housing, 1995, pp. 32-34.

[24] *Pre-Budget Submission: Recommended Changes to Federal Taxes on Housing*, Canadian Home Builders' Association, 2001, p. 11.

GST Treatment of Other Similar Businesses

As discussed above, a strong argument can clearly be made that, if the intent of the GST rebate is to equate the federal sales taxes on housing with those that applied prior to the GST, the rebate should be increased to roughly 4.5% – to reduce the effective rate of GST on housing to 2.5%. However, there is also a strong argument for fully removing rental housing from the tax base for the GST (i.e. zero-rating rental housing) or, alternatively, fully rebating the GST paid on the development cost of a new rental project.

Commercial Real Estate

The GST treatment of commercial real estate illustrates the anomalous situation of rental housing. Unlike rental housing investors, investors in non-residential properties (e.g. office and retail projects) effectively do not pay the GST. While GST is payable on the final value of a new non-residential building, the owners receive input credits for all GST paid – credits which can be applied against GST collected on rents from tenants, or refunded if they exceed GST collected.

This difference between the GST treatment of rental housing and non-residential rental properties is not clearly understood by many observers. It arises from the fact that, when the GST was introduced, a decision was made not to apply the GST to residential rents. Since commercial rents are subject to the GST, any GST paid on inputs by the owners of non-residential properties can be deducted against the GST collected from rents. In contrast, since residential landlords do not collect GST on rents, they are stranded with the GST they pay since there is no other GST collected on which it can be applied as a credit. Therefore, because no GST is payable on residential rents, rental housing is an exception from the general rule that the GST paid by businesses can be recovered from the purchasers of its products and services.

GST-Exempt Businesses

Residential rental housing is one of the few types of businesses in Canada that are 'GST-exempt' – other types of businesses treated similarly are health and dental services, financial services, day-care services, and educational services. These types of businesses pay GST on their inputs, but do not collect GST on their services. However, unlike rental housing, these are not typically capital-intensive businesses so their losses from being stranded with the GST they pay is relatively small compared to new rental housing investments.

Groceries – Zero-Rated Goods

The GST treatment of groceries is much more favourable than rental housing (another basic necessity). Like residential rents, no GST is collected on basic groceries. However, groceries are 'zero-rated goods' – i.e. no tax is collected on the final sale, but sellers can claim input tax credits on their purchases. Thus, all tax paid at the intermediate stages is stripped away and no tax is buried in the price. So, while GST does not apply to either groceries or residential rents, the providers of groceries (e.g. farmers) do not bear the GST – *no* GST is payable on many inputs (e.g. seed and fertilizer), and producers receive refundable input tax credits for those purchases on which GST is payable.

Rental Housing – Little GST Relief

Unlike the case with basic groceries (and non-residential buildings), the GST has raised the cost of new rental housing – which reflects back in higher required rents in order for investors to achieve the same return. The actual result has been a reduction in the attractiveness of investment in new rental housing – and tighter rental markets.

The justification for rental housing to receive the same type of treatment as basic groceries would be similar to the justification for zero-rating groceries: shelter (especially rental housing which is predominantly occupied by low and middle-income people) and food are basic necessities and a tax on such goods and services is regressive. Also, a similar argument for zero-rating can be made through comparison with the GST treatment of commercial rental properties – which do not bear the GST.

As a practical consideration, while a fairness argument can be made to zero-rate rental housing, such a change would have a very broad impact – across the total stock of existing rental housing, where GST is remitted on operating costs. This would have a very substantial impact on federal tax revenues. If rental housing was zero-rated for the GST, all rental landlords would be able to claim back credits on the GST paid on their operating expenses. Based on estimates presented in the Appendix (Section 5), the GST collected on operating costs from existing rental units is roughly $330-$420 million annually – a very significant figure.

One way to avoid this large tax expenditure, while retaining an incentive for new rental investment, would be to implement a full rebate of the GST payable on new rental development but retaining the current situation with respect to GST payments on operating costs – as occurs with other GST exempt activities (which do not typically involved large capital expenditures).

Effect of Fully Rebating or Zero-Rating Rental Housing

Exhibit 4-8 illustrates the effect of altering the GST payable on new rental housing (for the illustrative rental project presented in Exhibit 2-1) under three scenarios:

- **Reducing the GST to 2.5%** – reducing GST on new rental development to roughly the level of the FST which applied prior to 1991;
- **Fully rebating the GST on new rental housing** – rebating all of the GST payable on the development cost of new rental housing; and
- **Zero-rating rental housing** – not only rebating the GST payable on the development cost of new rental housing, but also rebating the GST payable on operating costs (assumed to total $100 annually).

Reducing the GST on new rental housing to 2.5% would have the impact of lowering the total cost of development – to $144,935. This reduces both the equity required and the mortgage amount – as well as the CMHC mortgage insurance fee (since the mortgage is less). The level of investor equity is determined as the difference between the development cost and the maximum loan. In the illustrative Toronto project, which includes higher rents than could be commanded in many Ontario markets, the lending value (based on NOI) is relatively high. Since the

maximum loan is based on the *lesser* of 85% of lending value or cost, the loan constraint with the reduced GST becomes the development cost and the maximum mortgage is therefore slightly less than in the base case.[25] However, most of the reduction in GST is reflected in reduced equity requirements, and a significant increase in the project's cash-on-cash return from 8.4% to 9.4%. The cap rate rises from 8.4% to 8.6%. These changes would certainly be positive for rental investment.

Exhibit 4-8:

Effect of Changes in GST Treatment of Rental Housing

($ per unit)

	Base Case	GST 2.5%	Full Rebate of GST	GST Zero Rated
Development Costs and Financing				
Land	24,400	24,400	24,400	24,400
Construction	117,000	117,000	117,000	117,000
GST	6,363	3,535 ←	0 ←	0
Project Costs	147,763	144,935	141,400	141,400
Equity	23,763	21,740	21,210	21,210
Mortgage Financing	124,000	123,195	120,190	120,190
Mortgage Insurance Fee	5,580	5,544	5,409	5,409
Total Mortgage	129,580	128,739	125,599	125,599
First Year Revenues, Costs and Cash Flow				
Revenues	16,300	16,300	16,300	16,300
Maintenance & Operations	2,000	2,000	2,000	1,900 ←
Property Taxes	1,900	1,900	1,900	1,900
Total Operating Costs	3,900	3,900	3,900	3,800
NOI	12,400	12,400	12,400	12,500
Mortgage Payments	10,415	10,348	10,095	10,095
Cash Flow	1,985	2,052	2,305	2,405
Cash-on-Cash Return	***8.4%***	***9.4%***	***10.9%***	***11.3%***
Cap Rate	***8.4%***	***8.6%***	***8.8%***	***8.8%***

The second option, fully rebating the GST on the development costs, further reduces the development cost – to $141,400. This leads to further reductions in the both the mortgage

[25] Projects with lower rents would generate a lower lending value, which would be the constraint on the maximum loan (rather than development cost). In these cases, the reduction in the GST would be directly reflected in a lower equity requirement (rather than a combination of lower equity and lower mortgage amount). This would magnify the impact of the reduction in GST on the return on equity because the denominator is smaller, even though cash flow is unaffected by the reduced GST amount.

amount and equity. With lower mortgage payments and lower equity, there is a further significant improvement in cash-on-cash return to 10.9%, while the cap rate would rise to 8.8% – a much more positive scenario than either the current situation or with the reduction in GST to 2.5%.

The third option, zero-rating would have a modest further beneficial effect on the economics of new rental development. In addition to fully rebating the GST on the development cost, zero-rating would eliminate the GST payable on project operations (e.g. repairs, utilities and management, etc.) so operating costs would be reduced as well. For the purposes here, this saving is estimated at $100 per unit per year. This leads to a further improvement in the cash-on-cash return to 11.3%.

Assessment

Effectiveness

There is little question that a further reduction in the GST payable on new rental housing would significantly enhance the attractiveness of new rental investment – particularly if there was a full rebate of GST payable on development costs. By reducing the total cost of the project, providing a full rebate of GST would reduce either the equity required from the investor, or the size of the mortgage (or both). In either case, the returns to an investor in new rental housing would be substantially enhanced and the investment would become much more attractive.

Zero-rating of rental housing would provide additional benefits to the investor. However, in terms of the goal of promoting investment in new rental housing, rebate of the GST currently payable on development costs would replicate most of the benefits which would flow from the more significant and symbolic step (for the federal government) of zero-rating rental housing.

Fairness

There appear to be strong arguments for eliminating (or at least reducing) the GST payable on rental housing on the basis of fairness:

- Even with the extension of the rebate to include new rental housing (as well as ownership housing), the GST has roughly doubled the federal sales taxes payable on new rental projects. This clearly has raised the cost of building new rental housing – and has, therefore, played a significant role in discouraging new rental investment.

- The differential treatment of new rental housing projects compared to non-residential rental projects appears extremely difficult to justify. Even if the GST rebate were increased to result in an effective rate of GST of 2.5% (to collect roughly the same share of project costs in federal sales taxes as under the FST), rental housing investors would still bear a substantial burden of GST – in contrast with investors in non-residential rental buildings which do not effectively bear any GST.

- The GST was intended to be a tax on final consumption – to be borne by consumers, not by business. It was intended to make Canada more competitive by removing federal

sales taxes from the cost base of businesses. While this might appear to be an argument in favour of differential treatment of rental housing versus non-residential rental buildings, in fact, ensuring an adequate supply of rental housing is a key factor in the performance of the economy as well. If, as is currently the case in many major markets in Canada, prospective employees have difficulty finding accommodation, businesses suffer just as much as if they face higher costs – and may in fact have to incur higher costs in the form of higher wages to encourage labour to locate in the area.

- It might be argued that rental housing already enjoys a benefit since it is GST-exempt – the tax expenditure from exempting residential rents is estimated at $1.2 billion annually.[26] However, such an argument appears disingenuous – given the fact that most tenants have relatively low or modest incomes. Raising rents for such tenants by 7% (2-3 times inflation) would be (and *was* at the time the GST was introduced) judged to be politically untenable – and, if it occurred, would likely have to be reflected in an increase in the GST credit for low-income people to offset the higher effective rents. Also, the political decision to exempt residential rents from GST (while requiring rental investors to 'eat' the GST they pay) has had the perverse effect of discouraging new supply, tightening rental markets, and causing higher rents than would otherwise be the case.

- Zero-rating residential rental projects would appear to be the logical solution to the current situation. Like groceries, rental housing is a basic necessity for low and modest income households. While the exemption of residential rents from the GST might appear to benefit such tenants, in fact, it has worsened their situation by discouraging new rental construction – with the follow-on effects of tightening rental markets and higher rents. In the competition for scarce rental units, low and modest income tenants suffer the most – landlords naturally prefer to rent to the most creditworthy tenants, and in tight markets they can choose.

In summary, there appear to be strong equity arguments in favour of zero-rating rental housing for the purposes of the GST. However, given the likely follow-on effects of zero-rating (in terms of revenue losses on GST collected from the operations of the large stock of existing rental housing), the more practical option would be to fully rebate the GST payable on development costs. This would provide the lion's share of the benefits in terms of improving the returns from new rental investment, without the significant revenue losses to the federal government which would result from zero-rating of all rental housing.

Practicality

Fully rebating (or reducing) the GST on the development costs of new rental housing would be relatively straightforward – rather than collecting 4.5% GST (with refunds of input tax credits as appropriate), all GST input tax credits would be refunded. Zero-rating would involve some administrative changes, but does not appear difficult to implement. Other businesses (e.g.

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[26] Finance Canada, *Tax Expenditures, 2001*, Table 3. The estimated tax expenditure for zero-rating basic groceries is $3.4 billion in 2001, while the estimated tax expenditure for the GST credit (for low-income taxpayers) is $2.9 billion. The tax expenditure associated with rebates for new rental housing projects is estimated by Finance Canada at $35 million in 2001 and $45 million in 2002.

grocery producers) are zero-rated, so the required procedures are well-established. Such a measure would be fully targeted to the rental housing sector – no other sector need be affected.

The potential revenue loss from fully rebating GST paid on the development costs of new rental housing would be relatively modest. Based on Finance Canada's tax expenditure estimates ($45 million for the 2.5% rebate in 2002), the 'loss' of GST from fully rebating GST on new rental projects would be roughly an additional $80 million annually. In fact, the revenue 'losses' would likely increase to the (desirable) extent that the measure would lead to additional rental development; however, this revenue 'loss' would be more than recaptured through other taxes (e.g. income taxes) generated as a result of increased volumes of new rental construction that might not have occurred in the absence of action on the GST – this is discussed further in Section 5 of this report.

If full rebates are provided for the development costs of rental housing, there may be some concerns on the part of the federal government that investors could 'profit' by structuring their development so as to avoid GST by initially renting the units (so no GST would be payable) and, subsequently, selling the units to owner-occupants as existing condominium units (and thereby avoiding payment of the GST). This could be discouraged by requiring payment of GST if a rental dwelling is sold to an owner-occupant within some stated period (e.g. 10 years).

4.8. Effect of the Potential Tax Changes on Investors' After-Tax Return

The preceding analysis has illustrated how each of the potential tax changes would affect the attractiveness of investment in a new rental project. Where possible, the effect of the potential changes on the investors' taxable income was calculated; however, it is not always possible to quantify the impact. The key criteria to measure how well each measure improves the attractiveness of rental investment is the after-tax cash flow and the rate of return on the initial investor equity required.

Exhibit 4-9 presents a comparison of the relative impacts of the three potential tax changes for which the effects on after-tax cash flow can be measured:

- Raising the CCA rate to 5% (but retaining the half-year rule);
- Allowing $5,000 in soft cost deductions; and
- Fully rebating the GST on rental housing.

The exhibit presents the after-tax cash flow to investors in the illustrative rental project in each scenario – after-tax cash flow includes the actual cash flow from the project, less any (federal and provincial) corporate taxes payable (or adding any taxes saved from the use of CCA and other losses from the project against income from other sources), together with the impact on level of investor equity required. For comparison purposes, the same variables (after-tax cash flow and equity) are presented for the current tax treatment. The calculations here are very complex so only a summary of the after-tax cash flow for each option is provided.

The estimates presented in the exhibit assume the building is completed in 2003 (i.e. 2003 is Year 1 (the rent-up year) in terms of the analysis presented earlier in this section and in Section 2), that the investor is a PBC, and that the basic federal and provincial corporate tax rates presented in Exhibit 4-6 apply – and that the 2005 tax rates apply to the 2006+ period. The annual after-tax cash flow is shown for the early years, as well as the present value of the after-tax cash flow over the 25-year (2003-2027) period. Finally, the exhibit presents the present value of the 25-year after-tax cash flow as a share of the equity in the project. After-tax cash flow (the return to the investor after accounting for all of the tax implications) and the return on equity are, of course, very important indicators of the attractiveness of a rental investment.

Exhibit 4-9:

Effect of Selected Tax Changes on Investor's After-Tax Cash Flow
Illustrative New Rental Project, Toronto, 2003-2027

	After-Tax Cash Flow ($ per Unit)					PV 2003-2027*		Initial Equity
	2003	2004	2005	2006	2007	$000	% of Equity	Required ($)
Current Tax Treatment	(1,507)	2,656	2,709	2,785	2,864	33.6	141.4	23,763
5% CCA (with half-year rule)	(1,294)	3,023	3,027	3,073	3,124	35.7	150.1	23,763
$5,000 Soft Costs	214	2,594	2,652	2,731	2,812	34.7	146.1	23,763
Full Rebate of GST	(1,325)	2,821	2,885	2,965	3,048	36.2	170.6	21,210

* at 6.5% discount rate

Key conclusions from the information included in Exhibit 4-9 include:

- There is substantial variation in the time profile of the impacts of each of the various measures compared to the current tax treatment.
- In Year 1 (2003), $5,000 in soft cost deductions has the largest impact – it actually results in positive after-tax cash flow. The higher CCA and full rebate of GST result in a modest reduction in negative cash flow, compared to the current tax treatment.
- Over the 2004-2007 period, the after-tax cash flow is greater for the 5% CCA change and the GST changes compared to the current tax treatment. The $5,000 soft cost deduction results in a lower after-tax cash flow in the years following 2003 compared to the current tax treatment.
- Discounting to 2002 values (using a 6.5% discount rate), the present values of the after-tax cash flows over the 2003-2027 period range from $34,700 (soft costs) to $35,700 (5% CCA) and $36,200 (full rebate of the GST) – compared to $33,600 with the current tax treatment.
- As a percent of the initial equity investment in the project, the present values of the after-tax cash flows range from 146.1% for the $5,000 soft cost option, to 150.1% with the 5% CCA option, and 170.6% with the full rebate of GST option. These are all more

favourable to the investor than the 141.4% with the current tax treatment; however, the full rebate of GST has by far the most significant impact.

The relative performance of these potential measures is totally dependent on the assumptions with respect to the change. For example, a higher rate of CCA (say 6%), would have a significant impact on the after-tax cash flow from the CCA option. Similarly, a higher allowable soft cost deduction would raise the after-tax cash flow from that shown in Exhibit 4-9.

After-Tax Cash Flow if 1980 Tax Rules with Respect to CCA, Soft Costs and Federal Sales Taxes Applied

The final exhibit in this section (Exhibit 4-10) presents the same information as Exhibit 4-9 with the addition of estimates of the after-tax cash flow and equity which would accrue to an investment in the illustrative rental project with three key differences from the current situation:

- 5% CCA without the half-year rule – the 5% rate applied prior to 1988; the half-year rule was introduced in 1981.
- Substantially greater immediately deductible expenses – currently, only landscaping costs ($700) are immediately deductible and mortgage insurance fees ($5,580) are deductible over a period. Until 1981, immediately deductible soft costs included both of these plus a variety of other costs – e.g. interest and property taxes during construction, legal fees, levies, etc. In total, immediately deductible soft costs are estimated at almost $18,000 – this large deduction leads to substantially greater after-tax cash flow in the first year.
- Lower sales taxes – during the last half of the 1970s and early 1980s, there was a 5% federal sales taxes on building materials. This is reflected in a modest increase in the construction costs of the project – to $119,260 from $117,000. The GST did not apply so the total development cost of the project is $143,660 – compared to the current total cost (with GST) of $147,763).

Exhibit 4-10:

Effect of Selected Tax Changes on Investor's After-Tax Cash Flow
Illustrative New Rental Project, Toronto, 2003-2027

	After-Tax Cash Flow ($ per Unit)					PV 2003-2027*		Initial Equity
	2003	2004	2005	2006	2007	$000	% of Equity	Required ($)
Current Tax Treatment	(1,507)	2,656	2,709	2,785	2,864	33.6	141.4	23,763
5% CCA (with half-year rule)	(1,294)	3,023	3,027	3,073	3,124	35.7	150.1	23,763
$5,000 Soft Costs	214	2,594	2,652	2,731	2,812	34.7	146.1	23,763
Full Rebate of GST	(1,325)	2,821	2,885	2,965	3,048	36.2	170.6	21,210
1980 CCA, Soft Costs & FST	5,354	2,587	2,629	2,686	2,746	40.8	189.4	21,549

* 2002 value of 2003-2027 after-tax cash flow at 6.5% discount rate

Clearly, the tax treatment of rental investment was much better under these tax rules – which applied in 1980. With the large immediately deductible soft costs plus the 5% CCA with no half-year rule, the after-tax cash flow in the first year is over $5,000 per unit – much preferable (to an investor) than the current tax treatment which results in a negative after-tax cash flow. In subsequent years, the after-tax cash flow is less than under the current tax treatment, because of the large amount of immediately deductible expenses (and hence a lower depreciable balance). The present value of the after-tax cash flow over the first 25 years is $40,800 – well above the $33,600 under the current tax treatment.

As a percentage of the initial equity required, the present value of the after-tax cash flow is 189.4% – well above the 141.4% with the current tax treatment. This is a function of both lower initial equity required (because of lower federal sales taxes) and the higher after-tax cash flow in the initial year.

This analysis is presented to illustrate how much the changes in the tax treatment of rental housing since the 1970s have dampened the potential returns from rental investment – and, therefore, the attractiveness of rental investment. And, this analysis does not include other important changes in the tax treatment of rental housing, such as capital gains tax (which did not apply prior to 1972), the ability to pool investments and defer CCA recapture in the event of a sale of rental property (which was allowed prior to 1972), or the very favourable (10%) CCA rate allowed for wood-frame buildings during the period prior to 1978.

On the other hand, the estimates in Exhibit 4-10 do not take account of the higher corporate tax rates which applied during this period – so the returns from rental investment in 1980 would have been less than those shown. However, these higher tax rates would have applied to *all* types of corporate income – so, it would appear that the attractiveness of rental investment compared to other types of investments would have been better in 1980 than today.

Most of the existing stock of private rental housing was built during the 1960s and 1970s, prior to these tax changes. Since 1980, most new rental housing has been subsidized in one form or another.

PBCs ceased being as active in rental investment in the early 1970s, despite the fact that many of the unfavourable tax changes did not occur until the early 1980s – so the tax changes cannot be regarded as responsible for all of the slowdown in investment. There are likely a variety of reasons behind the reduction in PBC rental investment – including the very high interest rates during the 1970s (which made rental investment uneconomic), the imposition of rent controls in 1975, attractive alternative investments (in the form of condominiums and tax sheltered MURBs), as well as tax changes such as the introduction of the capital gains tax and the removal of pooling and the ability of investors to avoid CCA recapture if another building of the same class is purchased.

The key message here is that tax changes are not the only factor which impacts on the attractiveness of rental investment – but they are still important. Now, with lower interest rates and a more benign rent control regime, there is significant interest in rental investment in the development community. However, the tax regime is much less favourable today than in the periods of high rental activity in the 1960s and 1970s.

5. Fiscal Impact of Potential Tax Changes

All of the potential tax changes will impact the federal treasury – and by virtue of linked tax policy and rates, most will also impact provincial treasuries. This section first examines the tax expenditure impact of each change, if implemented on a stand-alone basis. Subsequently, the extent to which additional rental development also generates new revenue is discussed, and, finally, the net impact of each measure is estimated. These expenditure and revenue impacts are presented here in overview. Details behind the derivation of the estimates are provided in the Appendix.

As is discussed below, for some of these potential changes, it is not feasible to estimate the tax impacts on the federal government while, for others, such estimates are possible only with a series of limiting assumptions – these are presented in the Appendix.

Revenue impacts will be a function of the volume of new rental construction to which the tax changes are applied. Prior to presenting the estimated tax impacts, the likely volume of rental starts in 2002 is estimated.

Estimated 2002 Rental Starts

In 2002, CMHC forecasts there will be 13,465 purpose-built rental units started in Canada.[27] However, some of these units will likely be developed by non-profit corporations (to which most taxes, except for the GST, do not apply). For the purposes here, it is estimated that roughly 75% of 13,465 purpose-built rental starts in 2002 will be undertaken by taxable private developers – about 10,000 units.

In addition, investor-owned rental condominiums must be considered. CMHC forecasts that condominium starts will total 33,185 units in 2002. Traditionally, a portion of condominium units are purchased by investors who then rent them out – so these are effectively rental units on which investors can utilize some of the tax opportunities available to investors in rental housing. The share of condominiums which are rented out varies from city to city – and over time. Currently, given low vacancy rates, it is likely that a sizeable proportion are rented. Previous analyses have indicated that up to 30%-35% of new condominium units are rented out in Vancouver and Toronto – though the figure is likely substantially lower in smaller centres.

Assuming that roughly 25% of all new condominiums (across Canada) are purchased by investors (and are, therefore, considered to be rental properties for tax purposes), the total rental condominium starts in 2002 would likely total about 8,000 units.

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[27] This CMHC forecast (from the CMHC National Housing Outlook) includes both 'private' and 'assisted' rental housing (as well as life-lease projects). According to CMHC, 'assisted' rental housing starts will total 800 units in 2002; however, these exclude provincial unilateral assisted housing programs which have accounted for significant volumes of new housing in some provinces in recent years – particularly BC and Quebec. With the federal-provincial rental incentive program, the number of non-profit starts is likely to rise in the next few years – here we assume that non-profit developments account for 3,500 units of the roughly 13,500 rental units annually.

Adding purpose-built rental starts and investor-owned rented condominium units yields total rental starts of roughly 21,500 units – of which approximately 18,000 units would be privately-owned (and, therefore, might benefit from the potential changes to the income tax treatment of rental housing).

The following cost impact estimates are premised on these currently projected levels of new rental construction. To the extent that these tax measures are expected to improve the attractiveness of rental investment, an additional increment of new development is likely, although this cannot be readily quantified. So, for illustrative purposes, three levels of additional rental starts are assumed – increments of 5,000, 10,000 and 15,000 units.

CMHC has developed projections of potential housing demand with sub-projections of rental demand. For the 1996-2011 period, CMHC projects potential new rental demand of 45,000-50,000 units annually. Through the 1990s, actual production levels have been and remain well below the projected levels. In part, this is because not all demand is met from new construction – non-conventional units (e.g. rented condominiums and basement apartments) comprise an important part of the rental stock. Also, with low interest rates, many more renter households are able to afford homeownership – so the CMHC projections may overstate rental demand. Nonetheless, the dramatic decline in rental apartment vacancy rates across Canada in the past several years suggests that supply is not meeting the demand for new rental accommodation. On this basis, it is not unreasonable that, given some incentives to improve the attractiveness of rental development, incremental production of 5,000-15,000 new units annually might be feasible.

Tax Expenditure Impacts on the Federal Government from Potential Tax Changes

Section 4 of the Appendix presents detailed estimates of how the potential tax changes will impact federal tax revenues. Because the impact estimates apply to rental construction across the country, it is not appropriate to base these estimates on the illustrative Toronto project used in earlier sections of this report. Instead, average project costs of $90,000-$120,000 are assumed for this analysis of tax expenditure impacts.

In order to determine the revenue impacts of the tax changes, it is also necessary to make some assumptions regarding the type of investor – in most cases, it is assumed to be a PBC taxed at the federal corporate tax rates shown earlier in Exhibit 4-6. Also, since these potential tax changes affect taxable income on an ongoing basis, and since the impacts are spread over a lengthy period of time, the federal revenue impacts are assessed over a 25-year operating period and presented based on the discounted present value of foregone tax revenues.

Estimates of federal revenue impacts are presented for the following three potential tax changes:

- Increasing the CCA rate on rental housing to 5%;
- Allowing investors to deduct $5,000 in soft costs rather than capitalize them;
- Full rebate of GST for new rental housing.

Exhibit 5-1 presents estimates of the aggregate impact of the three potential tax changes. For CCA and soft costs, the estimates are based on the present value of tax expenditures on 2002 rental starts over a 25-year period. For GST, they are the revenue losses from full rebates of GST on the development costs of 2002 rental starts. The estimates do not yet include the incremental impact of any additional units stimulated by the tax measures – this is added later in this section (Exhibit 5-3). In each case, low/high estimates of the impacts are presented – based on a range of average values for new rental buildings (see the Appendix).

Exhibit 5-1:
Impact of Potential Tax Changes on Federal Revenues on Current Forecast Production

	5% CCA		$5,000 Soft Cost		Full Rebate GST	
	Low	High	Low	High	Low	High
Units Affected	18,000	18,000	10,000	10,000	21,500	21,500
Impact Per Unit ($)	990	1,320	700	700	4,050	5,400
Total Foregone ($Million)	18	24	7	7	87	116

Highlights of Exhibit 5-1 include:

- The number of units affected varies depending on the particular change examined. Only the full rebate of GST affects the total 21,500 new rental units forecast above. The CCA change does not impact non-profit corporations. Restoring soft cost deductibility would affect only PBCs (estimated to account for 10,000 new units).

- The CCA change assessed here reflects only an increase from a 4% to 5% rate – it does not consider the effect of eliminating the half-year rule. The impact of the increased rate is a reduction in taxes of $18-$24 million. This is the present value of the taxes foregone on 2002 production over the next 25 years.

- Allowing deduction of $5,000 in soft costs in the first year (instead of being added to the capital base and depreciated), would result in tax expenditures of $7 million. If implemented in concert with a change in the CCA rate there would be a combined effect since the depreciable cost base would change – this is not reflected in these stand-alone assessments. A larger allowance for soft cost deductions (similar to the deductions allowed in the 1970s) would be a multiple of this estimate – e.g. $10,000 in soft cost deductions would result in a tax expenditure of $14 million.

- Fully rebating the GST collected on new rental development clearly would have the largest single impact – a tax expenditure of $87-$116 million.

For the other four potential tax changes examined in Section 4, it is more difficult to develop estimates of the revenue impacts, since this will depend on the potential participation of a particular target group (e.g. small investors in new rental development) as well as their current

circumstances. Nonetheless, the tax impacts of these other potential changes are unlikely to be significant, especially if the measure is restricted to new rental construction. For example:

- It is unlikely that many small investors (that might qualify for the lower small business tax rate) would construct new units – most tend to acquire existing properties.

- Extending the CCA to non-PBCs would apply mainly to individuals purchasing condominium properties which they then rent out. Currently, CCA can be used to reduce income to zero, but cannot be used to create a loss. The analysis in Section 4.2 showed that use of CCA by individuals is restricted mainly in the early years of an investment – and, even then, almost three-quarters of the available CCA is in fact used to achieve zero taxable income. So only the remaining 25% would be implicated in a change to permit CCA to create a loss and to apply this loss against other sources of income. The main effect would be a shifting of tax liability into future years – and the small incremental increase in use of CCA in early years would be largely offset by reduced CCA claims in future years.

- The deferral of capital gains and CCA recapture if the proceeds from a sale are reinvested in rental housing would similarly result in a *deferral*, rather than elimination of the tax liability. The taxes foregone would depend on the extent to which there is a capital gain and exposure to CCA recapture – but, in any event, the tax would only be postponed, not forgiven, and would likely be more than offset by the revenue generated from new production resulting from the reinvestment stimulated by this measure.

- The impact of elimination of the federal capital tax depends on the tax situation of the investor. As noted in Section 4.6, corporate income taxes can be used as a credit to replace federal capital taxes. In any case, the federal revenue impact would be relatively small.

Offsetting Revenues from Rental Construction Activity

As discussed, implementing any of the potential tax changes will result in a reduction in the amount of tax revenues collected by the federal government. This is not a new *expense*; it is a *reduction in revenue*. As such, it is appropriate to examine this revenue loss in the context of the substantial new federal revenues generated by new rental construction.

Detailed estimates of the revenues generated from rental construction are presented in the Appendix (Section 3). The amount of these revenues is a direct function of the volume of new construction – both the base forecast of 21,500 starts in 2002, and any incremental additional rental starts stimulated by the potential tax changes.

The Appendix identifies five main sources of federal revenues that are impacted directly by new rental construction: personal and corporate income taxes, GST, and Canada Pension Plan (CPP) and Employment Insurance (EI) contributions. Although CPP contributions flow into a separate account (the CPP reserve fund), all five sources are included here. The estimates presented for these five revenue sources do not cover all federal revenues from new rental production.

Revenues would also flow to other parts of the federal treasury (e.g. profits from CMHC insurance, duties on imported building materials, reduced EI claim payments from construction workers, etc.) as a result of rental construction, but these are not quantified in this analysis.

Exhibit 5-2 presents both the estimated revenues from currently forecast 2002 rental construction, and the revenue impact of increments of 5,000 and 10,000 additional units which might result from initiatives to encourage new rental production.[28] These revenue estimates are based only on the federal revenues which accrue from the *development* of rental housing in 2002; the estimates do not include the federal revenues which will be generated from the future *operation* of these projects, or the taxes paid by investors in these projects.

Exhibit 5-2:

Aggregate Federal Revenues from New Rental Development

	Revenue per Unit ($)		Impact for 21,500 units ($ Millions)		Impact for Assumed Increment of Newly Stimulated Units ($Millions)			
					5,000		10,000	
	Low	High	Low	High	Low	High	Low	High
Personal Income Tax	9,600	12,000	206	258	48	60	96	120
Corporate Income Tax	2,400	3,600	52	77	12	18	24	36
GST	6,700	8,700	144	187	34	44	67	87
CPP	2,600	3,300	56	71	13	17	26	33
EI	2,400	2,900	52	62	12	15	24	29
Total	23,700	30,500	510	656	119	153	237	305

Highlights of Exhibit 5-2 include:

- With the anticipated annual starts of 21,500 units (including private rental, investor-owned but rented individual condominium units, and non-profit units) total federal revenues from new rental construction are estimated to range from $510-$656 million.
- An increment of 5,000 rental starts would generate additional federal revenues of $119-$153 million. Incremental starts of 10,000 would double this additional federal revenue.

Assessing the Net Fiscal Impact of Proposed Tax Changes

Exhibits 5-1 and 5-2 have presented estimates of the cost (tax expenditure) associated with implementing some of the potential tax changes, and the revenues generated by rental construction. The combination of these estimates can be used to determine the net impact on federal revenues from adopting the potential changes.

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[28] It is not possible to estimate the likely increase in rental starts without more extensive analysis. The extent of the impact on rental production will depend on the specifics of the tax changes, and developers' assessment of the effect of these changes on the economics of rental investment. To some extent, there may be a substitution effect, whereby higher rental starts are offset by lower starts of condominiums. However, given the extremely tight rental markets in Canada (the number of vacant rental apartment units in major Canadian centres declined by almost 20,000 units over the 1999-2001 period, according to data from CMHC), there would appear to be ample room for a large increase in rental starts without significant reductions in other housing starts.

The revenue estimates in Exhibit 5-2 include both the revenues associated with the base level of new rental construction already forecast, and the incremental revenues which would flow from three potential levels of additional rental production which might be stimulated by adopting the tax changes. The estimates presented in Exhibit 5-1 related only to the foregone revenues from currently forecast units which would result from adopting the potential tax changes.

In Exhibit 5-3 the net impact of the incremental new units which might be generated from adoption of 5% CCA, $5,000 soft cost deductions, and full rebate of GST is presented. Each potential change is presented on a stand-alone (low/high basis), so the net benefits are not cumulative. In the case of the income tax measures, which affect federal revenues over a lengthy period, the revenue loss estimates are the present value of future revenue losses associated with the measure over 25 years. The GST rebate has a one-time effect in the year of completion so no present value estimates are necessary.

Exhibit 5-3:

Net Impact of Potential Changes on Federal Revenues

($Millions)

	5% CCA		$5,000 Soft Cost		Full Rebate GST	
	Low	High	Low	High	Low	High
Revenues from Current Forecast Production						
Current Revenue *(Exhibit 5-2)*	510	656	510	656	510	656
Total Foregone with Tax Change *(Exhibit 5-1)*	18	24	7	7	87	116
Net Revenue with Tax Change	492	632	503	649	423	540
Impact of 5,000 Incremental Units						
Revenues with No Tax Change *(Exhibit 5-2)*	119	153	119	153	119	153
Reduction from Tax Change	5	7	4	4	20	27
Actual Revenues from New Units	114	146	116	150	99	126
Foregone Revenue from Current Production	18	24	7	7	87	116
Net Impact of 5,000 Incremental Units	96	123	109	143	12	10
Impact of 10,000 Incremental Units						
Revenues with No Tax Change *(Exhibit 5-2)*	237	305	237	305	237	305
Reduction from Tax Change	10	13	7	7	41	54
Actual Revenues from New Units	227	292	230	298	197	251
Foregone Revenue from Current Production	18	24	7	7	87	116
Net Impact of 10,000 Incremental Units	209	268	223	291	109	135
Total Revenues from Rental Production (with Tax Changes)						
Current Production	492	632	503	649	423	540
- Plus 5,000 Incremental Units	606	779	619	799	522	666
- Plus 10,000 Incremental Units	719	924	733	947	619	791

Examining each of the main sections in the exhibit in turn:

- **Revenues from current forecast production** – this combines information from Exhibits 5-1 and 5-2:
  - **Current revenue:** the estimated revenue which will accrue to the federal government from 2002 rental production;

- **Total foregone with tax change:** the revenue which would be lost on 2002 rental production with each of the potential tax changes examined here (5% CCA, $5,000 in deductible soft costs, and full rebate of GST); and
- **Net revenue with tax change:** the difference between current revenue and the revenue losses resulting from the tax change. These are the estimated revenues which will accrue to the federal government from 2002 rental production if the tax changes are implemented.

The potential income tax changes would have only a modest impact on federal government revenues from current forecast rental production ($18-$24 million for 5% CCA, $7 million for $5,000 in soft costs – these are the present value of foregone revenues over 25 years). The full rebate of GST would have a more significant impact on federal revenues ($87-$116 million).

- **Impact of 5,000 incremental units:** this presents the estimated federal revenue impacts assuming the potential tax changes generate an additional 5,000 units of new rental production from PBCs. It consists of the following steps:

  - **Revenues with no tax change:** the revenues which would accrue to the government from 5,000 additional units if there was no change in taxes;
  - **Reduction from tax change:** the estimated reduction in the above revenues as a result of the tax change;
  - **Actual revenues from new units:** the difference between the above two lines – the revenues accruing to the federal government from the incremental units;
  - **Foregone revenue from current production:** from above – the revenues which would be lost on current forecast 2002 production (21,500 units) as a result of adopting the tax change; and
  - **Net impact of 5,000 incremental units:** the net effect on federal revenues of each of the potential tax changes, assuming that the changes stimulate the production of 5,000 additional rental units. So, if adoption of 5% CCA resulted in 5,000 incremental new rental units (in addition to current forecast rental production of 21,500 units), the federal government would receive a net increase in revenues of $96-$123 million. If providing a full rebate of GST resulted in 5,000 incremental rental units, the federal government would receive a net increase in revenues of $10-$12 million.

- **Impact of 10,000 incremental units:** this is double the impacts shown in the 5,000 incremental unit section – except for the foregone revenue from current production which, of course, remains the same for each measure.

- **Total revenues from rental production (with tax changes):** the actual federal revenues which would be generated by new rental production (current plus incremental production) if the tax changes are implemented.

The key conclusions which can be drawn from Exhibit 5-3 include:

- Even if the implementation of the potential tax measures generates only a modest number of new rental starts, the federal government would benefit. The federal revenues from

new rental construction are so substantial that an increase of only a relatively small number of new units would have a net beneficial impact on federal revenues.

- An increment of 5,000 rental starts will generate additional federal revenues of $119-$153 million (not accounting for the revenue losses). However, the revenue losses associated with implementation of any one of the three quantified measures are less than this additional revenue.

- Assuming incremental rental starts of 5,000 units, the net impact of each individual measure presented here more than offsets the cost of the revenue losses associated with applying the measure across the base 21,500 units already forecast – for example, 5,000 additional units generate a net revenue gain to the federal government of:

  - $96-$123 million for the change in CCA to 5%;
  - $109-$143 million for $5,000 in immediately deductible soft costs; and
  - $10-$12 million for full rebates of the GST on development costs.

- If the tax changes result in a higher level of incremental rental production, the revenue benefits to the federal government are more substantial. For 10,000 incremental units, the federal government enjoys a revenue gain of:

  - $209-$268 million for the change in CCA to 5%;
  - $223-$291 million for $5,000 in immediately deductible soft costs; and
  - $109-$135 million for full rebates of the GST on development costs.

Although not shown on the exhibit, production of roughly 6,000 incremental units fully covers the revenue losses incurred by extending *all three* of these changes across the base forecast of 21,500 units. New development beyond this level would generate an overall revenue gain for the federal treasury, even accounting for the revenue losses from existing production which would result from the tax changes.

In sum, the potential tax changes examined here would result in higher rental production, while the foregone federal revenues would be at least partially offset by additional revenues from the increased volume of rental construction. At the same time, as a direct consequence, the higher volume of rental production would lead to healthier housing markets. The new rental supply would help to relieve current very tight rental markets which, in turn, would reduce upward pressure on rents and effectively moderate the degree to which rising rents (caused in part by lack of supply coupled with new demand from population and household growth) exacerbate affordability problems.

6. Overall Assessment of the Potential Tax Changes

This analysis has demonstrated that each of the seven potential changes in federal taxes on rental housing could, to some degree, have a positive effect in improving the attractiveness of new rental investment, and could stimulate additional rental construction. The report examines each of the potential tax changes in terms of:

- Effectiveness – would the measure improve the attractiveness of rental investment and result in increased new rental housing production?
- Fairness – is the measure justifiable in terms of equity with other similar types of investments?
- Practicality – would the measure be simple to implement, with the potential to target most of the benefits exclusively to investors in new rental housing projects?

Exhibit 6-1 presents an overview of the assessment of each of the seven potential tax changes – based on the above three criteria. This exhibit also presents the potential tax changes in order of priority – based on an overall assessment of each according to the three criteria.

Exhibit 6-1:

Assessment of Potential Tax Changes

	Effectiveness				Fairness	Practicality	
	Per Unit Change in After-Tax Cash Flow ($)*		Change in Per Unit Initial Equity ($)	Effect in Generating New Rental Investment		Simple to Implement	Easily Restrict to New Rental Housing
	Year 1	PV (25 yrs)					
Full rebate of GST on rental housing	182	2,597	2,553	Both lowers equity required and improves cash flow	Rental housing investors treated very differently from both other types of rental property, and other basic necessities (e.g. groceries)	Yes	Yes
Deferral of capital gains tax and recaptured CCA upon re-investment in rental housing	n/a	n/a	-	Difficult to quantify but provides important new source of investment capital	Rental property currently treated differently from other types of capital assets	Yes	Yes
Increase in CCA to 5%	213	2,079	-	Improves after-tax cash flow	Accelerated CCA allowed for some other types of investments	Yes	Yes
Restoration of soft cost deductibility ($5,000)	1,721	1,129	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Elimination of capital tax on rental housing	n/a	n/a	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Allowing small landlords to qualify as small businesses	n/a	n/a	-	Limited number involved in new development	Investors in rental housing appear to be treated differently from other types of small businesses requiring hands-on management	Yes	No
Extension of eligibility for CCA losses	n/a	n/a	-	Yes (for non-PBCs)	Life insurance companies are allowed to use CCA losses against other income	Yes	Yes

* The change in after-tax cash flow compared to the current tax treatment

The cash flow estimates are based on the illustrative new Toronto rental project pro forma. For each measure, the impact on taxable income and after-tax cash flow is estimated. For some of the potential tax changes, it is neither feasible nor practical to develop a detailed cost impact, since there are too many unknown variables that influence the result.

It would be possible for the federal government to undertake each of the changes on a stand-alone basis and, for the purpose of assessment, is much simpler to present this way. However, this is not intended to imply that only one of the identified changes could, or should, be selected for implementation – clearly, a combination of tax changes would have a more significant impact on the economics of new rental development than implementing only one of the tax changes.

In the assessment of the effectiveness of each potential change, where possible, the exhibit presents estimates of the effect of each change (with the specific parameters assumed in this analysis) on the investor's after-tax cash flow – both for the initial year and over time (on a 25-year present value basis). The longer-term present value assessment is considered more meaningful than the initial year snapshot, especially in the case of the potential changes where tax liability is deferred.

These estimates reflect the difference between the after-tax cash flows under current tax rules and those that would be in effect if the proposed tax changes were implemented – thus the prioritization takes into account the degree to which the potential tax changes improve the attractiveness of investment. The exhibit also assesses the impact on the initial level of equity investment required. These estimates are from Exhibit 4-9.

Effectiveness

Almost all of the potential tax changes are considered likely to have some effect in generating new rental production, although some have a larger and broader impact than others.

Full rebate of the GST has an immediate impact in lowering the level of investor equity required and has a follow through favourable impact (not shown in this exhibit) on the investors return on equity. Full rebate of GST would also benefit *all* types of rental investors – not just those which pay income taxes. Restoring immediate deductibility of all (or some) soft costs would have the largest quantifiable impact on after-tax income in the critical first years following project completion. In terms of after-tax cash flow over time, the full rebate of GST and raising the CCA rate to 5% have the largest impact of the three potential changes where impact quantification is feasible.

Some of the potential changes defy quantification. For example, allowing owners of existing rental properties to defer any capital gains tax and CCA if the proceeds are reinvested in a rental property of equal or greater value would not directly effect cash flow, but could have a very significant impact in providing the new capital investment necessary to fund new development. For this reason, the potential change is ranked as the second highest priority.

Based on the analysis here, fully rebating the GST on rental housing, deferral of capital gains tax and recaptured depreciation (upon reinvestment in rental housing), increasing the CCA rate, and

restoration of soft cost deductibility would be the most effective measures in stimulating new rental investment. The other measures have a positive impact and could be effective complementary measures, but alone are not considered likely to have as significant an impact.

Fairness

Several of the potential tax changes would rectify some degree of inequity in the current tax environment, compared with the tax treatment of other types of investments:

- **Deferral of capital gains tax and recaptured depreciation upon re-investment in rental housing** – such deferral is allowed for other types of capital investments if the investor purchases another similar investment. In this regard, rental real estate is treated differently from other types of capital investments.

- **Fully rebating rental projects for the GST** – an investment in new rental housing attracts 4.5% GST, unlike commercial rental properties which effectively do not bear the GST. In this regard, rental housing is treated differently from other types of real estate investments. An equity argument in favour of full rebates can also be made in comparison with the GST treatment of basic groceries – another basic necessity. Groceries are zero-rated – i.e. GST is neither collected on the sale of groceries (like the case with rental housing) nor payable on the inputs required to produce groceries (unlike the case with rental housing). While a fairness argument can equally be made to zero-rate rental housing, such a change would have a very broad impact – across the total stock of existing rental housing, where GST is remitted on operating costs. Accordingly, this analysis deals with a full rebate that can more exclusively be targeted towards the development cost of new rental housing.

- **Allowing small landlords to qualify as small businesses** – businesses which invest in and manage real estate are effectively barred from qualifying for the small business deduction. In this regard, they are treated differently from other types of businesses which require hands-on management. Instead of recognizing that they must actively manage their rental properties, small real estate businesses are treated the same as businesses which invest in stocks, bonds and other types of passive investments.

- **Increasing the CCA rate and extension of eligibility for CCA losses** – on the basis of existing inequities in the tax system, a case can also be made for increases in the CCA rate and extension of eligibility for CCA losses to other types of investors. Some investments (e.g. aircraft) are allowed much greater accelerated depreciation. Similarly, life insurance companies are allowed to claim CCA losses on rental investments against other income but this is not allowed for other non-PBC types of investors.

Practicality

In the case of the CCA revisions, the report examines a number of broader options, in addition to increasing the rate to 5%. These other options include relaxing the half-year rule, and changing

the method from a declining balance to straight-line depreciation (as used in the US). Since these represent fundamental change across the entire Canadian income tax system, they are not considered practical – only the increase in the CCA, which could be implemented solely for new rental housing, is included in this assessment.

Similarly, zero-rating rental housing might be justified on the basis of fairness; however, this may not be practical due to the broad scale impact of such a change on federal revenues. Therefore, full rebate of the GST on the development cost of new rental housing is the potential measure considered here. It would provide most of the benefits of zero-rating (in terms of enhancing the attractiveness of investment in new rental housing), without the significant cost implications (or administrative changes) associated with zero-rating.

Other than these issues, none of the potential tax changes would appear particularly difficult to implement. They would require modest changes in tax policy and procedures, but such measures are routinely undertaken by the federal government.

Also, most of the measures could relatively easily be restricted to new rental housing so, if desired, the measures could be targeted exclusively to benefit new rental production. This would help to ensure that the impacts are well targeted and would limit the associated impact on federal tax revenues.

Appendix

Estimates of Federal Government Revenues from Rental Housing Construction and Impact of Potential Tax Changes

1. Introduction

This appendix presents estimates of the impacts on federal government revenues which would result from implementing the potential tax measures examined in the report. By their nature, these types of estimates involve assumptions which may be open to some debate – therefore, the estimates presented here should be considered as relatively rough approximations of the likely range of revenue impacts.

Estimates of the revenue *losses* associated with the measures must also be balanced with a consideration of the revenue *gains* which will accrue to the federal government as a result of additional new rental production. The appendix first presents estimates of employment impacts from housing construction (an input for the later analysis), then estimates of the revenues which accrue to the federal government from new rental production. Estimates of the impacts of the various potential measures on federal government revenues are then presented. The final section presents estimates of the net cost-benefit to the federal government from adopting the measures.

2. Employment Impacts from Housing Construction

CMHC undertook a series of economic impact studies in 1997-1998; the results were presented in *Research Highlights Issue 69 – Economic Impacts of Residential Construction*. The reports were based on the University of Toronto FOCUS model, and the Informetrica TIM model. The Research Highlight did not provide the detail required to produce estimates required here, and the detailed reports themselves did not provide this information in an easily accessible form, though they provided sufficient background information to allow such estimates to be derived. The estimates here are based on additional information (provided by Mr. Ron Hirshhorn, the author of the CMHC *Research Highlight*) regarding the employment impacts of new residential construction, based on information in the detailed CMHC studies. These additional estimates by Mr. Hirshhorn were prepared for the Canadian Home Builders' Association.

The key findings with respect to the employment impacts of residential construction include:

- The estimated employment impacts of an average new housing unit (based on information from the FOCUS model) are summarized in Exhibit A-1 – under three scenarios:

  1. High growth, fixed exchange rates, normal imports
  2. Low growth, flexible exchange rates, normal imports
  3. High growth, fixed exchange rates, double imports.

- The employment impacts are disaggregated into three distinct rounds of activity:

  – Direct (on-site) jobs – these are the tradespeople and other workers involved in the actual construction of the homes.

- Indirect jobs – these are jobs created in industries which supply inputs to construction – e.g. architectural services, building materials, lumber dealers and other suppliers.
- Induced jobs – these are jobs created in the general economy by the expenditure of incomes by workers generated in the direct and indirect rounds. These jobs include workers in all types of industries which provide goods and services to families and individuals.

Exhibit A-1: Employment Impacts of an Average Dwelling Unit, Canada
(Person Years)

	Scenario 1	Scenario 2	Scenario 3
Direct Impacts			
Construction	1.0	1.0	1.1
Ancillary	0.2	0.2	n/a
Total	1.2	1.2	n/a
Indirect Impacts			
Construction	1.0	1.0	0.8
Ancillary	0.2	0.2	n/a
Total	1.2	1.2	n/a
Induced Impacts			
Construction	0.6	3.5	0.5
Ancillary	-	0.7	n/a
Total	0.6	4.2	n/a
Total Impacts			
Construction	2.6	5.5	2.4
Ancillary	0.4	1.1	n/a
Total	3.0	6.6	n/a

- The total employment impacts of an average new housing unit in Canada vary from roughly 3 person-years to 6.6 person-years – depending on various assumptions with respect to economic growth (high or low), exchange rates (fixed or flexible), and level of imports. These estimated employment impacts include the impacts resulting from so-called 'ancillary expenditures' (e.g. land development, infrastructure investment and various professional services) which should legitimately be included in such estimates of the total employment impact of residential construction (unfortunately, the impacts of ancillary expenditures were not provided for Scenario 3).

- As is evident from Exhibit A-1, the wide variation in the estimates is entirely due to differing volumes of impacts in the induced round – i.e. those impacts in the general economy due to the expenditure of incomes generated in the first two rounds of activity. These range from 0.6 person-years in Scenario 1, to 4.2 person years in Scenario 2. In Scenario 3, they would likely have been in the 0.5-0.6 range.

- It seems likely that the high (6.6 person-year) estimate of total impacts of a new housing unit is an outlier and should be disregarded for the purposes of presenting employment estimates for residential construction.

Based on the above, the total impact for an average new housing unit would appear to be roughly 3 person-years per unit – i.e. essentially Scenario 1 (above). It should be noted, however, that this is a relatively rough average which will vary depending on economic conditions, as well as the unit sizes and amenities of the dwellings. The breakdown of the employment impacts would be as follows:

- Direct impact: 1.2 person-years
- Indirect impact: 1.2 person-years
- Induced impact: 0.6 person-years

The recent CMHC research did not examine the relative impacts of apartment units versus single-family units; however, based on the previous research, and estimates of the relative average costs of new rental apartment units versus 'average housing units', it appears that new apartment units would generate roughly 2-2.5 person-years of employment in total.

3. *Revenues to the Federal Government from New Rental Production*

Development of new rental housing projects results in substantial tax revenues for all levels of government. The focus here is on the revenues to the federal government.

Exhibit A-2 presents a summary of the breakdown of total federal government revenues for the 2000-2001 fiscal year – from the December 2001 Federal Budget.

Exhibit A-2: Federal Government Revenues
2000-2001

	$Millions	%
Income Taxes		
Personal Income	82,300	46
Corporate Income	28,200	16
Other	4,300	2
Total	114,800	
Employment Insurance Revenues	18,700	10
Excise Taxes/Duties		
Goods and Services Tax	25,000	14
Customs Import Duties	2,800	2
Other Excise Taxes and Duties	8,300	5
Total	36,100	
Total Tax Revenues	169,700	
Non-Tax Revenues	8,900	5
Total Budgetary Revenues	**178,600**	100

Source: Finance Canada, Federal Budget 2001

The majority of revenues to the federal government arise from four sources: personal and corporate income taxes, GST and Employment Insurance contributions. These four revenue sources account for over 85% of the total revenues to the government. These estimates exclude Canada Pension Plan contributions, which flow into a separate account – the CPP reserve fund. It seems reasonable to expect that the majority of the revenues flowing to the government from new rental investment would flow from the above four revenue sources, plus the CPP – these are the revenue sources examined below.

The following federal revenue estimates are based on 10,000 units of new rental housing.

Personal Income Taxes

As noted in Section 2, new apartment construction generates an estimated 2-2.5 person-years of employment – this includes direct on-site jobs, indirect employment to provide the goods and services to the construction project, and 'induced' employment in the overall economy.

According to Canada Customs and Revenue Agency (CCRA) *Taxation Statistics* data, the average income in 1999 (the latest year available) was roughly $39,800 (all taxable returns). Allowing for the fact that construction workers make more than the average income, and that incomes have risen since 1999, an average income for the employment generated by new apartment construction of $42,000 is assumed. With average deductions of $3,700 (from *Taxation Statistics*), the average taxable income of each of the workers would be $38,300. Allowing for typical tax credits, the federal income taxes for someone with a taxable income of $38,300 would be roughly $4,800.

For 10,000 new apartment units at 2-2.5 person-years of employment each, the total federal personal income taxes would be roughly:

Federal personal income taxes: ***$96-$120 million***

Corporate Income Taxes

There is no reliable basis for estimation of the actual amount of corporate income taxes which would flow from typical rental apartment construction. For simplicity here, estimates of federal corporate taxes are derived through the use of a ratio applied to the estimated personal income taxes which result from rental construction (above).

Total federal corporate income taxes collected over the 1997-2001 period were equivalent to about 30% of the average personal income taxes collected. Revenue projections in the 2001 Federal Budget indicate a ratio in the 29%-32% range over the next few years. Since the estimated personal income taxes (above) were based on an assumed average personal income (generated from the apartment construction) higher than the overall average, a lower ratio (25%-30%) is assumed for the purposes here. With this assumption, the total federal corporate income taxes resulting from the construction of 10,000 new apartment units would be roughly:

Federal corporate income taxes: ***$24-$36 million***

GST

The GST payable on a new rental building is 4.5% of the total value of the building. Rental property values vary substantially across the country – from less than $75,000 per unit in some locations to $180,000 per unit or more in major centres such as Toronto. For Canada as a whole, it seems likely that the average new rental unit would be valued in the $90,000-$120,000 range. At 4.5%, the average GST collected on these buildings would be $4,050-$5,400 – $41-$54 million for the 10,000 new apartment units.

However, this is just the GST on the rental project itself. In addition, GST would be collected on the goods and services purchased as a result of the spending of incomes generated to the workers in the three rounds of employment activity. Recall that the average income of the 2-2.5 workers per unit was estimated at $42,000 (above in the personal income tax section). Based on an analysis of data from the Statistics Canada Survey of Household Spending, an average of approximately 45% of household income is spent on GSTable goods and services – the remainder consists of income taxes, savings, purchases of non-GSTable goods and services, etc.. The GST collected on purchases by a household with the average ($42,000) income would therefore be roughly $1,323 [.07 x (45% of $42,000)/1.07]. For 10,000 units with 2-2.5 average workers per unit, this would lead to GST collections of $26-$33 million.

Therefore, adding the two sources of GST receipts, the GST collected on the 10,000 new apartment units would be roughly:

GST: ***$67-$87 million***

Canada Pension Plan

According to CCRA *Taxation Statistics*, individual CPP contributions averaged $520 per taxable return in 1999. Allowing for the increases in CPP rates, the higher incomes accruing to construction workers, and the fact that employers match the contributions of individuals, a figure of $1,300 in total CPP contributions per worker has been assumed. Under this assumption, the total CPP contributions for 10,000 new apartment units would be roughly:

CPP contributions: ***$26-$33 million***

Employment Insurance Premiums

According to CCRA Taxation Statistics, individual Employment Insurance premiums averaged $490 per taxable return in 1999. With the employer's contribution, the average would be roughly $1,175 per worker.

EI contribution rates are declining, but construction workers have higher than average incomes. For the purposes here, it is assumed that these two offsetting factors balance out, so EI contributions average $1,175 per worker. Under this assumption, the total EI premiums for the construction of 10,000 new apartment units would be roughly:

EI premiums: ***$24-$29 million***

Total Federal Revenues from New Rental Construction

Based on the above analysis, the federal revenues generated by the construction of 10,000 new rental apartment units are estimated to total roughly $237-305 million (on a rounded basis) – or $23,700-$30,500 per unit. These estimates do not include government revenues generated from the on-going operation of rental properties.

Exhibit A-3: Estimated Federal Government Revenues from New Rental Housing Construction
Canada

	10,000 Units ($Millions)	Per Unit ($)
Income Taxes		
Personal Income	96 - 120	9,600 - 12,000
Corporate Income	24 - 36	2,400 - 3,600
GST	67 - 87	6,700 - 8,700
CPP	26 - 33	2,600 - 3,300
Employment Insurance	24 - 29	2,400 - 2,900
Total	**237 - 305**	**23,700 - 30,500**

The CPP revenues are shown here as being part of total federal government revenues. As noted above, CPP contributions flow into a separate account (the CPP reserve fund).

The estimates in Exhibit A-3 almost certainly underestimate the actual positive impact of 10,000 new rental units on federal government finances. Some revenues (e.g. gasoline taxes, customs duties on imports, etc.) have not been included. Also, to the extent that the higher employment would result in reduced expenditures on such programs as EI, the net balance of revenues/costs to the government would be improved. CMHC premiums (likely amounting to $2,500-$4,500 per unit) are also excluded here – these premiums flow to a reserve fund to pay future claims, but also comprise part of CMHC's profits, which flow ultimately to federal coffers.

Therefore, it seems likely that the above analysis understates the benefits to the federal government of an increase in rental apartment construction.

4. *Estimates of Revenue Impacts on the Federal Government from Potential Tax Changes*

This section presents estimates of the revenue impacts on the federal government which would result from the implementation of the following potential changes to federal taxes on rental housing (these changes are described in detail in the main body of the report):

- Revising the rate and method used to calculate capital cost allowance (CCA) on rental housing
- Allowing all investors in rental housing to utilize CCA losses in determining income for tax purposes – not just principal business corporations (PBCs)

- Allowing investors to deduct soft costs rather than capitalize them
- Allowing rental investors to defer capital gains tax and recaptured depreciation upon the sale of a rental project if the proceeds are reinvested in rental housing
- Allowing small landlords to qualify as small businesses for the purposes of obtaining the small business corporate tax rate
- Eliminating the capital tax on rental housing
- Full rebates of GST on new rental development, or zero-rating of rental housing.

As is discussed below, for some of these potential changes, it is not feasible to estimate the tax losses to the federal government while, for others, such estimates are possible only with a series of limiting assumptions. The estimated tax impacts presented here are assumed to apply to rental projects started in 2002 – prior to presenting these estimated tax impacts, the likely volume of rental starts in 2002 is estimated.

For income tax changes (e.g. CCA and soft costs), there would also be an impact on provincial government revenues (assuming they maintained the same basis for calculating corporate and personal income taxes from rental investments). Provincial revenue impacts are not included in the estimates presented here.

Number of Rental Starts

In developing estimates of the tax losses, it is necessary to determine first the potential volume of rental units which will be impacted by the potential tax changes. In 2002, CMHC forecasts there will be 13,465 purpose-built rental units started in Canada.[29] However, some of these units will likely be developed by non-profit corporations (to which most taxes, except for the GST, do not apply). For the purposes here, it is estimated that roughly 75% of total purpose-built rental starts in 2002 (13,465) will be undertaken by taxable private developers – about 10,000 units.

In addition, investor-owned rental condominiums must be considered. CMHC forecasts that condominium starts will total 33,185 units in 2002. Traditionally, a portion of condominium units are purchased by investors who then rent them out – so these are effectively rental units on which investors can utilize some of the tax opportunities available to investors in rental housing. The share of condominiums which are rented out varies from city to city – and over time. Currently, given low vacancy rates, it is likely that a sizeable proportion are rented. Previous analyses have indicated that up to 30%-35% of new condominium units are rented out in Vancouver and Toronto – though the figure is likely substantially lower in smaller centres.

Assuming that roughly 25% of all new condominiums (across Canada) are purchased by investors (and are, therefore, considered to be rental properties for tax purposes), the total rental condominium starts in 2002 would likely total roughly 8,000 units.

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[29] This CMHC forecast (from the CMHC National Housing Outlook) includes both 'private' and 'assisted' rental housing (as well as life-lease projects). According to CMHC, 'assisted' rental housing starts will total 800 units in 2002; however, these exclude provincial unilateral assisted housing programs which have accounted for significant volumes of new housing in some provinces in recent years – particularly BC and Quebec. With the federal-provincial rental incentive program, the number of non-profit starts is likely to rise in the next few years.

Adding purpose-built rental starts and investor-owned rented condominium units yields total rental starts of roughly 21,500 units – of which approximately 18,000 units would be privately-owned (and, therefore, might benefit from the potential changes to the income tax treatment of rental housing).

The following cost impact estimates are premised on these currently projected levels of new construction. To the extent that these tax measures are expected to improve the attractiveness of rental investment, an additional increment of new development is likely, although this cannot be readily quantified. The final section of the report presents estimates of the net impact of these measures under varying assumptions regarding incremental rental production generated.

Increases in CCA on Rental Housing

The following estimates assume that any increase in the CCA for rental housing would be restricted to *new* rental housing – as such, it would not apply to existing rental properties (even if they were acquired after the date of the change in CCA) or other types of rental real estate. For estimating purposes, it is assumed that the 18,000 2002 rental starts are completed at the beginning of 2003.

Average construction costs vary across the country but, overall, the initial depreciable balance for a new rental project would likely be in the $80,000-$100,000 per unit range.[30] Exhibit A-4 presents the CCA which would apply for two new rental projects completed in 2003 with initial depreciable balances of $80,000 and $100,000 (per unit) under three assumptions:

- Current tax treatment,
- Raising the CCA rate to 5% but retaining the 'half-year rule', and
- Raising the CCA rate to 5% and abolishing the 'half-year rule'.

The exhibit also presents the federal corporate tax rate for each year, and the estimated taxes deferred in each year as a result of the CCA claims. Taxes are assumed to be 'deferred' because, typically, much (if not all) of the CCA claimed will be 'recaptured' when the building is sold (see Section 4.4 of the main body of the report).

Exhibit A-4 shows the actual yearly CCA claimed for two buildings – one with an initial depreciable balance of $80,000 and another with an initial depreciable balance of $100,000. It also shows the taxes which would be deferred as a result of deducting the CCA from income – for the purposes here, it is assumed that the corporate tax rate applies (i.e. these are PBCs). The exhibit also presents the present value of the tax deferrals from the CCA deductions (assuming a discount rate of 6.5%) over the 25-year period from 2003 to 2027.

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[30] In Section 3 of the Appendix (relating to federal revenues from rental construction), total development costs of $90,000-$120,000 per unit range (including land and building) were assumed.

Exhibit A-4:

Effect of Changing CCA on New Rental Housing

	($ per Unit)					PV 2003-2027*
	2003	2004	2005	2006	2007	($000)
$80,000 Average Depreciable Balance						
CCA Claimed:						
Current Tax Treatment	1,600	3,136	3,011	2,890	2,775	27.2
5% CCA	2,000	3,900	3,705	3,520	3,344	31.7
5% CCA + No Half-Year Rule	4,000	3,800	3,610	3,430	3,258	32.8
Depreciable Balance at Start of Year:						
Current Tax Treatment	80,000	78,400	75,264	72,253	69,363	
5% CCA	80,000	78,000	74,100	70,395	66,875	
5% CCA + No Half-Year Rule	80,000	76,000	72,200	68,590	65,161	
Federal Corporate Tax Rate	*24.12%*	*22.12%*	*22.12%*	*22.12%*	*22.12%*	
Taxes Deferred:						
Current Tax Treatment	386	694	666	639	614	6.1
5% CCA	482	863	820	779	740	7.0
Difference from Current						0.9
5% CCA + No Half-Year Rule	965	841	799	759	721	7.3
Difference from Current						1.2
$100,000 Average Depreciable Balance						
CCA Claimed:						
Current Tax Treatment	2,000	3,920	3,763	3,613	3,468	34.0
5% CCA	2,500	4,875	4,631	4,400	4,180	39.6
5% CCA + No Half-Year Rule	5,000	4,750	4,513	4,287	4,073	41.0
Depreciable Balance at Start of Year:						
Current Tax Treatment	100,000	98,000	94,080	90,317	86,704	
5% CCA	100,000	97,500	92,625	87,994	83,594	
5% CCA + No Half-Year Rule	100,000	95,000	90,250	85,738	81,451	
Federal Corporate Tax Rate	*24.12%*	*22.12%*	*22.12%*	*22.12%*	*22.12%*	
Taxes Deferred:						
Current Tax Treatment	482	867	832	799	767	7.6
5% CCA	603	1,078	1,024	973	925	8.8
Difference from Current						1.2
5% CCA + No Half-Year Rule	1,206	1,051	998	948	901	9.2
Difference from Current						1.6

* at 6.5% discount rate

Key elements of this exhibit include:

- Under the current tax treatment, the present value of the taxes deferred from CCA on rental buildings valued at $80,000-$100,000 per unit would be $6,100-$7,600.
- If CCA were raised to 5%, the present value of these tax deferrals would be $7,000-$8,800 – i.e. $900-$1,200 more than the current tax treatment.

- If CCA were 5%, and the 'half-year rule' abolished, the present value of the tax deferrals would be $7,300-$9,200 – i.e. $1,200-$1,600 more than the current tax treatment.

These estimates assume that all new rental units are owned by PBCs – which clearly is not the case, particularly with the condominium rentals which make up 45% of the total forecast starts. Assuming the top federal marginal personal income tax rate of 29%, the CCA-related tax deferrals would be roughly 30% higher if the rental units were owned by individuals (see next section). Therefore, the average tax deferrals will be roughly 1.135 times those indicated above [(PBCs: 1.0 x 55%) + (individuals: 1.3 x 45%) = 1.135] – rounded to 1.1 since some of the individual investors may not be at the top marginal tax rate.

Assuming 2003 private rental housing completions of 18,000 units (see above), the present value of the foregone federal taxes associated with these measures would be:

- 5% CCA for new rental housing:
  - Present value of the average incremental tax deferral per unit: $900-$1,200 x 1.1 = $990-$1,320.
  - Total incremental federal tax deferrals: $990-$1,320 x 18,000 = $18-$24 million.
- 5% CCA plus abolition of the 'half-year rule':
  - Present value of the average incremental tax deferral per unit: $1,200-$1,600 x 1.1 = $1,320-$1,760.
  - Total incremental federal tax deferrals: $1,320-$1,760 x 18,000 = $24-$32 million.

These estimates likely overstate the actual incremental tax deferrals since some of the CCA assumed to be deducted by individual investors may not be deductible in the early years (because the unit may not be generating sufficient income). The effect of this on the estimates is not likely to be large.

Therefore, the present value of the additional deferral of federal income taxes which would result from an increase in CCA to 5% for the 18,000 rental completions assumed for 2003 is estimated to be roughly:

Federal income taxes: ***$18-$24 million***

If the 'half-year rule' were also abolished for new rental housing the present value of the additional deferral of federal income taxes would increase to $24-$32 million.

As with all the estimates presented here, these estimates do not take account of any increase in the volume of new rental housing as a result of the change in CCA treatment.

Extension of Eligibility for Use of CCA Losses to All Investors in New Rental

Exhibit A-5 presents a variation on the information presented in Exhibit A-4. It compares the tax deferrals for the $80,000-$100,000 rental units with current CCA deductions under two scenarios: basic federal corporate taxes (as in Exhibit 6), and the top federal personal income tax rate.

Exhibit A-5:

Personal Versus Corporate Tax Rates on CCA

	($ per Unit)					PV 2003-2027*
	2003	2004	2005	2006	2007	($000)
$80,000 Average Depreciable Balance						
Deductions Claimed	1,600	3,136	3,011	2,890	2,775	27.2
Depreciable Balance	80,000	78,400	75,264	72,253	69,363	
Tax Rates:						
Federal Corporate Tax Rate	*24.12%*	*22.12%*	*22.12%*	*22.12%*	*22.12%*	
Federal Personal Tax Rate	*29.00%*	*29.00%*	*29.00%*	*29.00%*	*29.00%*	
Taxes Deferred:						
Corporate Tax Rate	386	694	666	639	614	6.1
Personal Tax Rate	464	909	873	838	805	7.9
Difference from Corporate						1.8
$100,000 Average Depreciable Balance						
Deductions Claimed	2,000	3,920	3,763	3,613	3,468	34.0
Depreciable Balance	100,000	98,000	94,080	90,317	86,704	
Tax Rates:						
Federal Corporate Tax Rate	*24.12%*	*22.12%*	*22.12%*	*22.12%*	*22.12%*	
Federal Personal Tax Rate	*29.00%*	*29.00%*	*29.00%*	*29.00%*	*29.00%*	
Taxes Deferred:						
Corporate Tax Rate	482	867	832	799	767	7.6
Personal Tax Rate	580	1,137	1,091	1,048	1,006	9.9
Difference from Corporate						2.3

* at 6.5% discount rate

As illustrated in the exhibit, the use of CCA losses by individual investors results in roughly a 30% increase in tax deferrals compared to the situation with PBC investors – an average of $1,800-$2,300 (present value) in taxes deferred for each unit owned by an individual (assuming the top marginal tax bracket) rather than a PBC.

Under *current tax law*, individuals can use CCA to reduce income from rental property – though they cannot create a 'loss' using CCA. Thus, all other things being equal, extension of eligibility for use of CCA losses to *all* rental investors would result in a relatively small incremental increase in deferred taxes to the government – it would mean that some share of CCA deductions

would be moved forward from future years. The additional deferred taxes would apply to the early years only, and would be a share of the actual CCA available (some already can be used to reduce income from the property to zero – the analysis in the main body of the report indicated that roughly 75% of the potential CCA deduction is already used in the first five years by these investors to reduce income to zero, so only 25% remains available to be utilized by individuals if this measure is introduced). The small incremental increases in CCA claims in the early years would be largely balanced by reduced CCA claimable in later years, so the net tax deferrals (and, therefore, the effect on federal government revenues) would be relatively minor.

The potential tax deferrals from this measure could be much more significant if it led to a MURB-like proliferation of tax shelter investments – and a transfer of rental investment from PBCs to individuals. However, as discussed in the main body of the report, the government has introduced a number of measures specifically to discourage MURB-like tax shelters; this would likely preclude the widespread resurrection of such ventures.

Restoration of Soft Cost Deductibility

Exhibit A-6 presents similar information to Exhibits A-4 and A-5 – this time, comparing the current tax treatment (for PBCs) with the restoration of soft cost deductibility. For the purposes here, it is assumed that $5,000 in soft costs are deductible up-front (this amount can vary significantly depending on which costs are deemed to be eligible soft costs).

This change lowers the initial depreciable balance (by the $5,000 deducted as a soft cost) and therefore slightly reduces the available CCA deductions – at the 4% rate, with the half year rule lowering this to 2% in Year 1). Compared to the current tax treatment, the effect of deducting $5,000 in soft costs up-front, rather than depreciating the costs over time, is an increase in the first year deduction and lower annual deductions in the future (because of the reduced depreciable cost base – in 2003, the initial deduction is $6,500 [$5000 + (2% x $75,000)]. In present value terms, the result is that the $5,000 in up-front soft cost deductions results in roughly $700 less federal taxes collected over 25 years. The initial change impacts the depreciable base in later years, and consequently lowers future deductions.

Restoring soft cost deductions would only affect purpose-built rental units (not individually-owned condominiums).

The effect of restoring $5,000 in soft cost deductions for the expected 10,000 purpose-built private rental starts would be a reduction in tax revenues of roughly ($700 x 10,000):

Federal income taxes:	***$7 million***

If the allowed soft cost deductions were greater than $5,000 (i.e. if other costs were deemed eligible as part of this deduction), the tax losses would be correspondingly greater.

Exhibit A-6:

$5,000 in Soft Cost Deductions

	($ per Unit)					PV 2003-2027* ($000)
	2003	2004	2005	2006	2007	
$80,000 Average Depreciable Balance						
Deductions Claimed:						
Current Tax Treatment	1,600	3,136	3,011	2,890	2,775	27.2
Soft Costs + CCA	6,500	2,940	2,822	2,710	2,601	30.2
Depreciable Balance at Start of Year:						
Current Tax Treatment	80,000	78,400	75,264	72,253	69,363	
Soft Costs + CCA	75,000	73,500	70,560	67,738	65,028	
Federal Corporate Tax Rate	*24.12%*	*22.12%*	*22.12%*	*22.12%*	*22.12%*	
Taxes Deferred:						
Current Tax Treatment	386	694	666	639	614	6.1
Soft Costs + CCA	1,568	650	624	599	575	6.8
Difference from Current						0.7
$100,000 Average Depreciable Balance						
Deductions Claimed:						
Current Tax Treatment	2,000	3,920	3,763	3,613	3,468	34.0
Soft Costs + CCA	6,900	3,724	3,575	3,432	3,295	37.0
Depreciable Balance at Start of Year:						
Current Tax Treatment	100,000	98,000	94,080	90,317	86,704	
Soft Costs + CCA	95,000	93,100	89,376	85,801	82,369	
Federal Corporate Tax Rate	*24.12%*	*22.12%*	*22.12%*	*22.12%*	*22.12%*	
Taxes Deferred:						
Current Tax Treatment	482	867	832	799	767	7.6
Soft Costs + CCA	1,664	824	791	759	729	8.3
Difference from Current						0.7

* at 6.5% discount rate

Deferral of Capital Gains Tax and Recaptured CCA Upon Reinvestment in Rental Housing

This measure would defer the payment of capital gains tax and recaptured CCA upon the sale of a rental building, providing the proceeds were reinvested in another rental building. As such, there is no actual tax loss – simply a deferral of the collection of these taxes to some date in the future when the buildings purchased are sold. Because this is not 'new money', it simply leverages existing assets, this would provide an important source of capital for reinvestment in new rental construction. It is not possible to determine how many existing investors would take advantage of this option, nor is it possible to determine the current level of tax liability that would otherwise be triggered by a sale from their existing portfolio, so no quantification is possible for this change.

Allowing Small Landlords to Qualify as Small Businesses

There are no data on the number of small corporate rental landlords, nor is it known what share of any newly stimulated development would be undertaken by small corporate landlords. A further complicating factor is that it would be difficult to limit this measure to just new investment. Changing the eligibility to enable these operators to qualify for the lower small business tax rate would have a much broader effect and cost impact than just new development. Therefore, it is not considered feasible to formulate estimates of the potential cost of this measure.

Eliminating the Capital Tax on Rental Housing

Capital taxes apply to a variety of things, not just rental housing. Only corporate owners of rental properties with total taxable capital of $10 million or more face the capital tax – individuals who own rental units do not pay capital taxes, nor do pension funds, REITs or non-profit corporations.

The estimated 10,000 private purpose-built rental starts in 2002 are assumed here to be owned by corporations which pay the federal capital tax.

In the analysis on the GST collected on rental housing (Section 3), it was estimated that the average total development costs for new rental housing in Canada would be in the $90,000-$120,000 range. Annual capital taxes on these units would be $200-$270 per unit ($90,000-$120,000 x 0.00225). For 10,000 units owned by corporations, the one year cost to the federal government of exempting new rental housing from the capital tax would be roughly:

Capital tax:	***$2-$3 million***

In future years, this would cumulate so, the next year, the loss in capital taxes would be $2-$3 million for production that year, plus $2-$3 million for the previous year's production – and so on into the future. Over time, as corporations' portfolios change and they extract retained earnings, the tax liability will also fluctuate, so it is not possible to estimate a present value of future tax revenues foregone.

The actual amount of federal capital tax collected depends on the tax situation of the investor. As noted in Section 4.6, corporate income taxes can be used as a credit to replace federal capital taxes. To the extent that capital taxes are offset by corporate income taxes, the federal revenue impact of exempting new units from capital taxes would be less than the above estimates.

Full Rebate of the GST on Rental Housing

The average total development costs for new rental housing are estimated above to be in the $90,000-$120,000 range. The GST payable on rental units in this value range would be $4,050-$5,400 ($90,000-$120,000 x 4.5%).

Assuming that total rental starts in 2002 are 21,500 units, the GST foregone from either a reduction in GST to 2.5% or zero-rating of GST for new rental housing would be:

- Reducing GST from its current 4.5% to 2.5% would result in average GST collections of $2,250-$3,000 – a difference of $1,800-$2,400. For 21,500 rental units, this would mean foregone revenue of $39-$52 million.

- Eliminating GST would result in foregone revenue on newly constructed rental buildings of $87-$116 million.[31]

Therefore, the total annual cost to the federal government from full rebates of the GST paid on the development costs of new rental housing would be roughly:

GST: ***$87-$116 million***

If, on the other hand, rental housing was zero-rated for the GST, rental landlords to claim back credits on the GST paid on their operating expenses. An analysis by Crawford Patterson Campbell Chartered Accountants (*Fiscal Impact of Federal Tax Legislation on Residential Rental Rates in Canada*, prepared for the Canadian Federation of Apartment Associations in 1999) estimated that the GST payable on the operating costs for a typical rental apartment unit was $124. This included GST on a variety of expenses (e.g. management, repairs, etc.) which might in some cases be undertaken by landlords themselves (especially among small landlords). For the purposes here, it seems likely that the average annual GST payable on operating expenses for all rental units in Canada is less – more likely in the $80-$100 range.

According to the Census of Canada, there were 3.9 million occupied rental units in Canada in 1996. Allowing for vacant units, and rental completions since 1996, the total stock of rental housing today is likely about 4.2 million units. At $80-$100 per unit, the GST collected on these rental units would be in the order of $330-$420 million.

Therefore, the total annual cost to the federal government of zero-rating *all* rental housing would be roughly:

GST: ***$420-$530 million***

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[31] These estimates appear broadly consistent with estimates prepared by Finance Canada (*Tax Expenditures, 2001*, Table 3) on the tax expenditures associated with rebates of 2.5% of GST for new rental housing. According to Finance Canada, the tax expenditures associated with the 2.5% rebate are estimated at $35 million in 2001 and $45 million in 2002. Turning the estimates around, if $45 million will be foregone by rebating 2.5% of GST in 2002, then the actual estimated collections of GST on rental housing would be $81 million [$45 million x 4.5/2.5]. This is somewhat less than the $87-$116 million estimated above – the difference could be due to fewer expected rental completions, or lower estimated GSTable costs.

5. Overall Impact Assessment

Earlier sections of this appendix presented estimates of both federal revenues generated as a result of new rental development (Section 3) and the potential foregone revenue (i.e. tax expenditures), where quantifiable, of several of the potential tax changes. As noted in the introduction, both sets of estimates are highly dependent on a range of assumptions, and therefore cannot be considered definitive – though they are considered to represent the broad order of magnitude of federal revenues involved in each case.

This final section presents a comparison of the net impact of implementation of the measures. It compares the foregone revenues associated with each measure with the potential additional federal revenues which could result from the higher volumes of rental production generated by the measures. The above caveats in terms of the base estimates should be borne in mind – the results should similarly be treated as 'order of magnitude' estimates only.

Revenues

Exhibit A-7 presents the estimated revenues generated to the federal government from the five primary sources of federal revenues (based on information in Exhibit A-3).

Exhibit A-7:

Aggregate Federal Revenues from New Rental Development

	Revenue per Unit ($)		Impact for 21,500 units ($ Millions)		Impact for Assumed Increment of Newly Stimulated Units ($Millions)			
					5,000		10,000	
	Low	High	Low	High	Low	High	Low	High
Personal Income Tax	9,600	12,000	206	258	48	60	96	120
Corporate Income Tax	2,400	3,600	52	77	12	18	24	36
GST	6,700	8,700	144	187	34	44	67	87
CPP	2,600	3,300	56	71	13	17	26	33
EI	2,400	2,900	52	62	12	15	24	29
Total	23,700	30,500	510	656	119	153	237	305

It is expected that adoption of changes in the federal tax treatment of rental housing will have a stimulative effect and will result in additional new rental production. However, since the magnitude of this impact is unknown, two illustrative potential levels of additional incremental rental starts are identified. So, in addition to the actual estimated revenues associated with forecast 2002 rental starts (21,500 units), estimates are provided for potential additional federal revenues associated with higher numbers of rental starts – incremental increases of 5,000, and 10,000 starts.[32]

[32] The net increase in rental starts in unknowable without more extensive analysis. It will depend on the extent of the tax changes, and developers' assessment of the impact of these changes on the economics of rental investment. To some extent, there may also be a substitution effect, whereby higher rental starts are offset by lower starts of

With the anticipated starts of 21,500 units (including private rental, investor-owned but rented individual condominium units, and non-profit units) total federal revenues are estimated to range from $510-$656 million. Based on the estimates here, an increment of 5,000 rental starts will generate additional federal revenues of $119-$153 million. An increase in starts of 10,000 units will double the estimated additional revenues.

Cost Impacts

Exhibit A-8 presents estimates of the net impact on federal revenues of the three potential measures for which foregone revenue estimates were prepared in Section 4 (increase in the CCA to 5%, $5,000 in soft cost deductions, and full rebate of the GST for new rental production).

Exhibit A-8:

Net Impact of Potential Changes on Federal Revenues

($Millions)

	5% CCA		$5,000 Soft Cost		Full Rebate GST	
	Low	High	Low	High	Low	High
Effect on Revenues from Current Forecast Production						
Units Affected	18,000	18,000	10,000	10,000	21,500	21,500
Impact Per Unit	990	1,320	700	700	4,050	5,400
Total Foregone ($Millions)	18	24	7	7	87	116
Revenues from Current Forecast Production						
Current Revenue	510	656	510	656	510	656
Total Foregone with Tax Change	18	24	7	7	87	116
Net Revenue with Tax Change	492	632	503	649	423	540
Impact of 5,000 Incremental Units						
Revenues with No Tax Change	119	153	119	153	119	153
Reduction from Tax Change	5	7	4	4	20	27
Actual Revenues from New Units	114	146	116	150	99	126
Foregone Revenue from Current Production	18	24	7	7	87	116
Net Impact of 5,000 Incremental Units	96	123	109	143	12	10
Impact of 10,000 Incremental Units						
Revenues with No Tax Change	237	305	237	305	237	305
Reduction from Tax Change	10	13	7	7	41	54
Actual Revenues from New Units	227	292	230	298	197	251
Foregone Revenue from Current Production	18	24	7	7	87	116
Net Impact of 10,000 Incremental Units	209	268	223	291	109	135
Total Revenues from Rental Production (with Tax Changes)						
Current Production	492	632	503	649	423	540
- Plus 5,000 Incremental Units	606	779	619	799	522	666
- Plus 10,000 Incremental Units	719	924	733	947	619	791

condominiums. However, given the extremely tight rental markets in Canada, there would appear to be ample room for a large increase in rental starts without major reductions in other housing starts. The estimates in Exhibits A-7 and A-8 assume *incremental* starts of 5,000 or 10,000 (i.e. total starts of 5,000-10,000 in excess of what would have occurred in the absence of the tax measures) and that total employment will increase by 2-2.5 person-years per incremental unit above the employment that would have occurred in the absence of the tax measures.

For the other measures, it is not considered feasible to generate these types of net benefit estimates, since foregone revenue estimates have not been formulated.[33] For deferral of capital gains tax and recaptured depreciation, the tax revenue is not a loss to the federal government – it is *deferred* to a later time. The tax foregone would depend on the extent to which there is a capital gain and exposure to CCA recapture – but, in any event, the tax would only be postponed, not forgiven, and would likely be more than offset by the revenue generated from new production resulting from the reinvestment stimulated by this measure.

Focusing on the three quantifiable changes, Exhibit A-8 considers both the impact of these changes on units already anticipated to be built in 2002, and an assessment of the incremental impact of additional production that may be stimulated by these tax changes. Examining each of the six main sections in the exhibit:

- **Effect on revenues from current forecast production** – this presents, first, the volume of 2002 starts already forecast that would be impacted by the measure (18,000 private rental units in the case of the CCA change, 10,000 purpose-built private rental units for the soft cost change, and 21,500 total rental units for the GST change); next, the estimate of the range of federal revenue losses per unit (from Section 4); and, finally, the total estimated foregone revenue from each measure. In the case of the income tax measures, the revenue loss estimates are the present value of all future revenue losses associated with the measure.

- **Revenues from current forecast production:**

  - **Current revenue:** the estimated revenue which will accrue to the federal government from 2002 rental production (from Exhibit A-7);
  - **Total foregone with tax change:** the revenue which would be lost on 2002 rental production with each of the potential tax changes examined here (from above); and
  - **Net revenue with tax change:** the difference between current revenue and the revenue losses resulting from the tax change – i.e. the estimated federal revenues from 2002 rental production if the tax changes are implemented.

- **Impact of 5,000 incremental units:** this presents the estimated federal revenue impacts assuming the potential tax changes generate an additional 5,000 units of new rental production from PBCs. It consists of the following steps:

  - **Revenues with no tax change:** the revenues which would accrue to the government from 5,000 additional units if there was no change in taxes;
  - **Reduction from tax change:** the estimated reduction in the above revenues as a result of the tax change;
  - **Actual revenues from new units:** the difference between the above two lines – the revenues accruing to the federal government from the incremental units;

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[33] A first year estimate is presented for capital tax, but due to changes in a corporation's total capital base in future years, it is not possible to determine the longer term and present value impact of this change. Also, to the extent that corporate income taxes can be used as a credit to replace federal capital taxes, it is uncertain how much capital tax revenue would actually be lost to the federal government if new rental housing were exempt from capital tax.

- **Foregone revenue from current production:** from above – the revenues which would be lost on current forecast 2002 production (21,500 units) as a result of adopting the tax change; and
- **Net impact of 5,000 incremental units:** the net effect on federal revenues of each of the potential tax changes, assuming that the changes stimulate the production of 5,000 additional rental units. So, if adoption of 5% CCA resulted in 5,000 incremental new rental units (in addition to current forecast rental production of 21,500 units), the federal government would receive a net increase in revenues of $96-$123 million. If providing a full rebate of GST resulted in 5,000 incremental rental units, the federal government would receive a net increase in revenues of $10-$12 million.

- **Impact of 10,000 incremental units:** this double the impacts shown in the 5,000 incremental unit section – except for the foregone revenue from current production which, of course, remains the same for each measure.

- **Total revenues from rental project (with tax changes):** the actual total federal revenues which would be generated by new rental production (current plus incremental production) if the tax changes are implemented.

The information presented in Exhibit A-8 is discussed in detail in Section 5 of the main body of the report.

It should again be stressed that this analysis is based on rough cost and revenue estimates that depend on a variety of assumptions and estimates of indirect revenue impacts – e.g. the broad macroeconomic impact of construction-related employment. In this assessment, the calculations have not been premised on an econometric input-output simulation model and do not attempt to assess the degree to which there is displacement in the economy – i.e. whether this level of development would have occurred in the form of condominium development or whether it reflects the acceleration of development that might otherwise occur in future years. Nonetheless, given the extremely tight rental markets in major centres across Canada, there would appear to be room for some increase in rental production without offsetting reductions in other starts.

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